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No. 92-1074

IN THE
Supreme Court of the United States

October Term, 1992

JOHN HANCOCK MUTUAL LIFE
INSURANCE COMPANY,

Petitioner,

v.

HARRIS TRUST AND SAVINGS BANK,
AS TRUSTEE OF THE SPERRY MASTER
RETIREMENT TRUST NO. 2,

Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF AMICUS CURIAE
OF THE WESTERN CONFERENCE
OF TEAMSTERS PENSION TRUST FUND
IN SUPPORT OF RESPONDENT

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INTEREST OF AMICUS CURIAE

The Western Conference of Teamsters Pension Trust Fund ("WCT Fund") maintains a multiemployer pension plan with over 510,000 participants and beneficiaries, including 150,000 retirees and beneficiaries, and over 6,600 employers who contribute to the WCT Fund pursuant to collective bargaining agreements. The WCT Fund is one of the two largest multiemployer defined benefit funds in the country. It has approximately $11 billion in assets, over $1 billion of which is managed by an insurance company in its general account.

The WCT Fund shares in the variable investment return of the general account.[1]

The principal source of funding, aside from employer contributions negotiated through collective bargaining, is the WCT Fund's return on investments. If the returns on the Fund's general account assets were to be diminished or eliminated through actions of the insurance company, the Fund's ability to maintain overall benefit levels could be significantly affected. Accordingly, it is vitally important to the WCT Fund and the hundreds of thousands of participants and beneficiaries who rely on it for retirement security that the protections of the fiduciary responsibility provisions of ERISA remain intact with respect to its assets held in the insurance company general account.

SUMMARY OF ARGUMENT

The ultimate issue in this case is whether John Hancock Mutual Life Insurance Company ("Hancock") is a fiduciary, for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA"), with respect to an insurance contract ("GAC 50") issued to the Sperry Master Retirement Trust No. 2. The resolution of this issue turns on the nature of the funds underlying GAC 50. If any of those funds are deemed to be plan assets for purposes of ERISA, Hancock, by virtue of its management of those assets, would be an ERISA fiduciary with respect to those assets and would be subject to the strict rules governing ERISA fiduciaries. The Court of Appeals for the Second Circuit held that the so-called "free funds" under GAC 50 were plan assets and that Hancock was an ERISA fiduciary with respect to its handling of those assets.

Hancock and its *amici*, including the United States Department of Labor (the "Department" or "DOL"), contend that all of the assets underlying GAC 50 are entirely exempted from coverage by the

[1] Counsel for Petitioner and Respondent have consented to the WCT Fund's *amicus curiae* brief in letters filed with the Clerk of the Court.

fiduciary responsibility provisions of ERISA by reason of Section 401(b)(2) of ERISA, 29 U.S.C. § 1101(b)(2). The DOL contends, further, that its view on this matter has been consistent since the enactment of ERISA and that it is entitled to substantial deference.

Contrary to the assertions of Hancock and the DOL, the position now advocated by the DOL is not consistent either with its past pronouncements on this or related matters or with the intent of Congress when it fashioned the narrow exception in Section 401(b)(2).

On a number of occasions, the DOL has stated its view that Congress intended that, when an entity, including an insurance company, acts as a manager for a pooled investment vehicle in which a plan participates, such an entity is acting as an ERISA fiduciary and is subject to ERISA's fiduciary responsibility provisions. The DOL now takes a position that would ignore entirely the fact that a contract, such as GAC 50, is an investment vehicle under which the plan stands to gain or lose depending on the success of the insurer's investment activities. Instead, it would deny the protections of ERISA's fiduciary responsibility provisions, if at any time and to any degree, benefits are to be guaranteed by the insurer under the contract. This is a 180-degree turn from its long-held position regarding pooled investment accounts.

Congress clearly did not intend to exempt all contracts funded by insurance company general accounts from ERISA fiduciary regulation. It considered that option and rejected it. Instead, it chose a limited exception, which ensures that employee benefit plans and their participants and beneficiaries receive the full measure of protection afforded by ERISA when the plan is at risk with respect to an insurer's investment activities. The DOL's reading of Section 401(b)(2) would eliminate these protections and is wholly inconsistent with the intent of Congress. The strained interpretations offered by Hancock and the DOL run counter to well-established rules of statutory construction. Consequently, those interpretations must be rejected, and the DOL's position does not merit any deference.

Hancock and its *amici* also urge that the decision of the Court of Appeals be reversed because, they contend, (1) it will unduly disrupt the practices of employee benefit plans and insurers and (2) it is contrary to the allegedly long-held understanding of the insurance industry with respect to the scope of ERISA regulation of insurance company general account assets.

It is clear, however, that the practices of the insurance industry and pension plans will not be unduly disrupted as a result of the decision below. The holding below has been the law in the Seventh Circuit for a decade and there is no evidence of adverse consequences either to plans or to the insurance industry. Moreover, any concerns that are real can be addressed through existing administrative exemption procedures, which were fashioned by Congress to alleviate certain undesirable effects of the broad sweep of ERISA, while at the same time providing mechanisms which afford needed protections for plans and their participants and beneficiaries. There is no evidence that these existing exemption procedures are not adequate.

There is also no evidence that the decision below has caught the insurance industry by surprise. In fact, the record demonstrates that, ever since the enactment of ERISA, the industry has been well aware of and concerned with the limited exception from ERISA's fiduciary regulation afforded by Section 401(b)(2). However, rather than seeking to coexist with ERISA regulation of certain assets under general account contracts, it has sought to escape such regulation. It cannot now be heard to claim that it has relied on any understanding that its activities regarding the management of general account assets were wholly exempted from regulation under ERISA.

ARGUMENT

A. THE POSITION TAKEN BY THE DEPARTMENT OF LABOR IS CONTRARY TO THE CLEAR INTENT OF CONGRESS AND, THEREFORE, IS ENTITLED TO NO DEFERENCE.

The DOL argues that Section 401 (b) (2) of ERISA, 29 U.S.C. § 1101(b)(2),[2] exempts from all regulation under the fiduciary responsibility provisions of ERISA all assets held in insurance company general accounts under a contract which, at any time during its term, provides for the payment of fixed annuities. This position, in effect, would exempt from the protections afforded by ERISA all contracts funded through insurance company general accounts, even when the insurance company is making the very same type of discretionary management decisions that, if undertaken by another entity, would trigger the highest level of ERISA fiduciary obligations.

1. *The Department's Assertion That It Has Taken a Consistent Position on This Matter is Contradicted By the Record.*

a. The Relief Provided Under ERISA Interpretive Bulletin 75-2 Was Clearly Intended to be Limited to Prohibited Transactions and Was Not Intended to Apply to the General Fiduciary Responsibility Provisions of ERISA.

In an attempt to buttress its position, the DOL asserts that it has consistently taken the view that insurance company general account

[2] Section 401(b)(2) provides:

> In the case of a plan to which a guaranteed benefit policy is issued by an insurer, the assets of such plan shall be deemed to include such policy, but shall not, solely by reason of the issuance of such policy, be deemed to include any assets of such insurer. For purposes of this paragraph:
>
> . . .
>
> (B) The term "guaranteed benefit policy" means an insurance policy or contract to the extent that such policy or contract provides for benefits the amount of which is guaranteed by the insurer. Such term includes any surplus in a separate account, but excludes any other portion of a separate account.

assets are not plan assets for any purpose under ERISA. The cornerstone of this assertion is the DOL's claim that ERISA Interpretive Bulletin 75-2 (IB 75-2) was intended to apply to the general fiduciary duties provisions of Section 404 of ERISA, 29 U.S.C. § 1104, as well as to the *per se* prohibited transaction provisions of Section 406 of ERISA, 29 U.S.C. § 1106.[3]

However, the plain language of IB 75-2, the contemporaneous statement to Congress by the Assistant Secretary of Labor, and the context in which IB 75-2 was issued show without a doubt that IB 75-2 was intended to provide relief only from the prohibited transaction provisions of Section 406.

IB 75-2 itself made it absolutely clear that its purpose was to announce "rules for determining whether a party in interest has engaged in a prohibited transaction."[4] The DOL's claim that it was intended to be an interpretation of Section 401(b)(2)'s guaranteed benefit policy exception is not convincing, inasmuch as there is not one mention of that section or of guaranteed benefit policies anywhere in IB 75-2. It is also inconceivable that IB 75-2 could have been intended to apply to the general fiduciary duties provisions of Section 404, given that it made only one passing reference to those provisions.[5] Moreover, *all* of the substantive discussion in IB 75-2 focuses on party in interest prohibited transactions under Section 406.

The statement by Assistant Secretary of Labor, Paul J. Fasser, Jr., to the House Labor Standards Subcommittee during oversight hearings on ERISA shows unmistakably that the DOL's concern

[3] Section 404 sets forth general fiduciary obligations, such as prudence and diversification. Section 406 identifies conflict of interest transactions with a high potential for abuse, which are strictly prohibited. *Donovan v. Cunningham*, 716 F.2d 1455, 1464-65 (5th Cir. 1983).

[4] IB 75-2 as originally issued, *reprinted in* Pens. Rep. (BNA) No. 21 at R-7 (Feb. 10, 1975).

[5] The last sentence of IB 75-2 as it was issued in 1975 stated simply: "Further, the Department of Labor emphasized that it would consider a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the fiduciary responsibility provisions of the Act to be in contravention of the provisions of Section 404(a) of the Act."

when it issued IB 75-2 was solely with the broad impact and the *per se* nature of the prohibited transaction rules.[6]

As an example of the difficulties created by the prohibited transaction rules, Assistant Secretary Fasser described a large multiemployer plan (much like the Western Conference of Teamsters Pension Plan, which has thousands of contributing employers that are parties in interest[7]), that had purchased an insurance policy under which "the benefits [were] wholly insured, but not fully guaranteed."[8] He explained that the insurance company invested the premiums received from the plan along with premiums from other policyholders. After describing the difficulties created by the application of the prohibited transaction rules to these general account assets and with no reference whatsoever to the general fiduciary duties under Section 404, he went on to say that:

> We studied the law and the underlying rationale of the *prohibited transactions provisions*, we studied the legislative history, we conferred with our colleagues at the Internal Revenue Service, we applied our collective common sense, and we concluded that Congress did not intend this result [*i.e.*, application of the prohibited transaction restrictions]. We recognized that the prohibited transactions restrictions are designed to avoid conflict of interest situations, but we knew that where the premiums paid by a plan are placed in an insurance company's general asset account, along with assets of many other plans, the risk of any one plan being able to influence the investment policy of the insurance company respecting the general asset account is extremely slight.

[6] *Oversight on the Employee Retirement Income Security Act of 1974:* Hearings on Pub. Law 93-406 Before the Subcomm. on Labor Standards of the House Comm. on Education and Labor, 94th Cong., 1st Sess. 390-391 (1975) ("Oversight Hearings").

[7] The term party in interest, as defined under Section 3(14) of ERISA, 29 U.S.C. § 1002(14), encompasses a wide variety of persons with relationships to a plan, including contributing employers, service providers, sponsoring unions, and employees of such.

[8] Oversight Hearings at 390.

(emphasis added).[9] The Assistant Secretary never suggested that the Interpretive Bulletin (IB 75-2) was intended to address anything but prohibited transactions.

To understand the genesis of IB 75-2, it also is necessary to keep in mind that it was issued at the dawn of ERISA, when the broad sweep of the prohibited transaction provisions was the principal focus of concern,[10] but when the congressionally mandated procedures for promulgating administrative exemptions had not been developed.

Recognizing that the *per se* prohibited transaction rules would encompass many legitimate transactions, Congress authorized the Secretaries of Labor and Treasury to jointly issue administrative exemptions. Congress required the establishment of an exemption procedure, which, among other things, would require publication of proposed exemptions in the Federal Register, allow adequate time for public comment, and require public hearings in certain cases.[11] However, this procedure was not in place when the prohibited transaction rules took effect on January 1, 1975 and was not issued until April 28, 1975.[12] Moreover, the procedure contemplated by Congress — publication of a notice of pendency, a comment period, a public hearing, *and* coordination and cooperation between Federal agencies with substantially different goals — did not lend itself to a quick fix.

[9] *Id.* at 391.

[10] *See* Oversight Hearings, testimony of Assistant Secretary Fasser, 390-395; testimony of Commissioner of Internal Revenue, Donald C. Alexander, 473-475; testimony of Robert A. Georgine, President of AFL-CIO Building and Construction Trades Department, 358-360. The concern regarding the application of the prohibited transaction rules is understandable, in that they, unlike the general fiduciary duties provisions, are *per se* rules. A party in interest that engages in a prohibited transaction, no matter how innocent, is subject to stiff excise taxes under 26 U.S.C. § 4975, and a plan fiduciary that causes a plan to engage in the transaction is exposed to personal liability under Section 409(a) of ERISA.

[11] ERISA § 408(a), 29 U.S.C. § 1108(a).

[12] 40 Fed. Reg. 18471.

Therefore, although the DOL and the IRS had the authority to grant relief from the broad sweep of the prohibited transaction rules, they were not in the position in early 1975 to do so quickly and in compliance with the congressionally mandated procedure. Consequently, they resorted to the Interpretive Bulletin process to address several major areas of concern regarding the prohibited transaction provisions, including the impact of those provisions on the investment of assets in the general accounts of insurance companies.[13] IB 75-2 was the result.

Accordingly, it is clear that IB 75-2 was not intended to be an interpretation of Section 401(b)(2), nor was it intended to exempt general account assets from the general fiduciary duties rules. Moreover, any attempt to create such an exemption would have been completely unauthorized. By its own admission, the DOL does not have the authority to issue exemptions from the general fiduciary duties provisions of ERISA.[14] And, as is discussed below, an "interpretation" of Section 401(b)(2) which would entirely exempt general account assets from ERISA fiduciary regulation is contrary to the remedial purpose of ERISA and the clear intent of Congress.[15]

b. The Department's Advisory Opinions and the Development of the Plan Asset Regulation Evidence General Views Consistent with the Holding of the Second Circuit.

The administrative opinions of the DOL subsequent to the issuance of IB 75-2 reflect a consistent view that the fiduciary

[13] Oversight Hearings, Fasser at 391.

[14] Oversight Hearings, Fasser at 393-394. ("Exemptions from the general fiduciary responsibility provisions cannot be granted.")

[15] It should be noted that the DOL overstepped its authority when it promulgated IB 75-2 with respect to insurance company general account assets, because IB 75-2 is effectively a prohibited transaction exemption and the DOL did not publish a notice of proposed exemption, allow public comment, or hold a public hearing as required by Section 408(a). Accordingly, IB 75-2 could be challenged even with respect to its facially intended purpose. This was clearly a concern of the insurance industry. *See* Minutes of the American Council of Life Insurance ("ACLI"), September 16, 1976. Append. A-17. (The material in the Appendix accompanying this brief was obtained from the appendix attached to an *amicus curiae* brief filed with the Court of Appeals for the Third Circuit in *Mack Boring & Parts Co. v. Meeker Sharkey Moffitt*, 930 F.2d 267 (3d Cir. 1991).)

responsibility provisions should apply to the managers of pooled investment arrangements, including insurance companies. At the same time, however, DOL has exhibited uncertainty and confusion as to the nature of general account contracts. This uncertainty and confusion undoubtedly led to the paralysis of indecision evidenced in the DOL's inability to provide its views to the Court of Appeals below.

Advisory Opinion 78-8A (March 13, 1978), in which the DOL implicitly acknowledged that it did not understand the nature of the contracts that could be funded from general accounts, reflected the DOL's belief that it was the intent of Congress that "when an insurance company provides investment advice which determines the rate of return *to the plan* and its participants, the assets in the account shall constitute plan assets so that the insurance company is subject to the fiduciary responsibility provisions of the Act" (emphasis added). It went on to say that IB 75-2 "was not intended to modify or alter the basic statutory scheme of Section 401(b)(2) of the Act." This analysis properly ignores the label of the insurance company account (*i.e.*, general vs. separate), and goes to the heart of the matter -- the nature of the service provided by the insurance company (*i.e.*, investment management versus insurance).

A similar approach, also consistent with the congressional intent underlying Section 401(b)(2), was taken by the DOL in Advisory Opinion 83-51A. There again, the DOL ignored the label given to the account under the contract issued by the insurance company and looked to the substance of the contract. The DOL, in discussing the application of Section 401(b)(2), stated that, in its view, assets held in a *separate account* would *not* be plan assets if the contractual obligations of the insurance company were fixed *and* "if neither the amount *payable (or credited to) the plan* or to any participant or beneficiary of the plan (including an annuitant) is affected *in any way* by the investment performance of the separate account" (emphasis added).[16] The clear import of Advisory Opinions 78-8A and 83-51A is that substance should prevail over form. This is in keeping with the remedial purpose of ERISA and is in sharp contrast to the position now taken by the DOL in its *amicus* brief.[17]

[16] It is instructive that the DOL focused on payments to the plan as well as payments to participants and beneficiaries for purposes of the application of the Section 401(b)(2) exception for guaranteed benefit policies. This is contrary to the DOL's new position that a contract can be a guaranteed benefit policy even if there is a significant variable investment component.

The DOL's lack of understanding regarding the nature of general account contracts was again reflected in its first attempt at issuing regulations to give guidance on the meaning of "plan assets." In the preamble to its original proposed regulation, the DOL stated that:

> a functional analysis leads to the conclusion that with respect to a wide variety of pooled investment vehicles [such as general account contracts with variable return features], when a plan invests some or all of its assets in a pooled investment vehicle, the plan is, as a practical matter, retaining the management of that investment vehicle to manage that portion of the plan's assets which is so invested. *It would be unreasonable to suppose that Congress intended that the protections of the fiduciary responsibility provisions of the Act which are applicable when a plan retains a manager of its investments directly would not be applicable where the manager is retained indirectly, through investment by the plan in a pooled investment vehicle.*

(emphasis added).[18]

This, of course, is entirely consistent with the clear intent of Congress with respect to Section 401(b)(2). However, in the same preamble, the DOL's discussion of the application of Section 401(b)(2) suggests that it was not aware of the substantial investment components of many general account contracts. On the one hand, it notes in

[17] In its *amicus* brief, the DOL points to Advisory Opinion 75-79 as proof of its allegedly consistent approach to this matter. However, it appears from the meager facts set forth in that letter that the question presented to the DOL dealt with the fiduciary duties of, and the need for fiduciary insurance by, plan fiduciaries who select an insurance contract. Moreover, as the DOL effectively admitted in Advisory Opinion 78-8A, it did not have a full understanding in 1975 of the kinds of contracts that could be written from insurance company general accounts.

[18] 44 Fed. Reg. 50364 (August 28, 1979).

a footnote that it has interpreted Section 401(b)(2) to mean "generally that assets held in an insurer's general account *to support benefits* under a contract purchased by a plan are not plan assets" (emphasis added).[19] This would seem to suggest that the exception in Section 401(b)(2) was intended to apply only to those fixed assets currently supporting guaranteed benefits (as opposed to assets that have not been committed to support particular benefits or assets that are subject to variable returns). This too would be consistent with a narrow application of the Section 401(b)(2) exception.

However, in the further discussion in the text of the preamble, the DOL states broadly that, when a plan purchases a contract or policy funded through an insurance company general account, the assets of the plan "will not necessarily be deemed to include any assets of the . . . insurer."[20] It went on to state that this exception "appears to be based upon the fact that the plan benefits provided under such contracts or policies are insured by an entity which is subject to state regulation designed to assure the entity's ability to pay benefits specified in the policies when due."[21] Read in the context of its other statements quoted above, this suggests that the DOL was under the mistaken notion that contracts and policies funded by general accounts consisted principally of guaranteed benefits.

The regulation proposed in 1979, which included an explicit exception for general account contracts or policies, was never finalized and was withdrawn in 1985. It was replaced by a proposed regulation,[22] which was finalized in 1986.[23] Neither the reproposed regulation or the final regulation address this issue.

It is instructive to review briefly what transpired between 1979

[19] *Id.* at n. 4.

[20] *Id.* at 50364.

[21] *Id.*

[22] 50 Fed. Reg. 961 (January 8, 1985).

[23] 29 C.F.R. § 2510.3-101 (1986).

and 1986. First, as discussed below in Section C, the insurance industry was engaged in a continuous effort to elicit the support of the DOL in obtaining legislation which would provide the relief that Section 401(b)(2) clearly did not provide, *i.e.*, a broad exemption from ERISA fiduciary regulation for all general account assets, whether or not they were fixed, and funded guaranteed benefits. In addition, the Court of Appeals for the Seventh Circuit handed down a decision in 1983 which applies the Section 401(b)(2) exception narrowly in keeping with the intent of Congress.[24] Thereafter, representatives of the insurance industry met with the Department's ERISA Administrator to discuss a legislative solution regarding the industry's concern over the treatment under ERISA of general account contracts.[25] The DOL response makes it clear that, in 1984, the DOL realized that it needed a better understanding of the insurance products funded through general accounts.[26]

The insurance industry submitted additional information in late 1984 and met with representatives of the DOL on March 5, 1985. According to an ACLI memorandum dated June 28, 1985, the DOL's career staff found the ACLI's proposed legislation unacceptable, because the staff were concerned that no exception from coverage by ERISA's remedial provisions should be made in the case of, among other things, "contracts which are essentially indistinguishable from non-guaranteed separate account arrangements."[27]

The DOL's concerns regarding a complete exception for general account contracts were reflected in the fact that, despite the urging of

[24] *Peoria Union Stock Yards Co. Pension Plan v. Penn Mutual Life Ins. Co.*, 698 F.2d 320 (7th Cir. 1983)

[25] Letter from Robert A.G. Monks, Administrator of the DOL's Office of Pension and Welfare Benefits Programs to Richard Minck, Executive Vice President of the ACLI, dated June 1, 1984. Append. A-81.

[26] The DOL responded that it was not prepared to support the proposed legislation and that it needed "information regarding the different types of general account products which insurance companies offer, so that we could better understand the situation." *Id.*

[27] ACLI Memorandum, dated June 28, 1985. Append. A-88.

the ACLI,[28] it did not include in the final regulation the language from the 1979 proposed regulation which would have given a broad exemption for general account assets. All that the DOL was willing to do was to make the ambiguous statement in the preamble to the final regulations that "the portion of Interpretive Bulletin 75-2 dealing with contracts or policies of insurance is not affected by the regulation being issued here."[29]

Such was the state of affairs when in 1992, the Court of Appeals for the Second Circuit invited the DOL to provide its views on the issues before it in the case below. Remarkably, the DOL was unable to do so, even with an extension of time. In requesting the extension, the DOL admitted that it had *not* formulated a final position on the issue, that the case was complex, and that more time was needed to examine the legislative and regulatory history.[30] After an extension of almost three months, the DOL admitted that it needed still more time to consider fully all of the implications of the legal and policy issues involved, and declined to provide its views.[31]

Thus, any assertion that the DOL has held a consistent position that Section 401(b)(2) entirely exempts general account assets is belied by the record and the DOL's own admissions.

2. The Department's View is Not Entitled to Deference.

a. The Department's Position Is Contrary to the Clear Intent of Congress.

While it is true that the courts must give due deference to the views of agencies charged with statutory administration,[32]

[28] *See* Memorandum of March 5, 1985 meeting with DOL. Append. A-83.

[29] 51 Fed. Reg. 41272, 41278.

[30] *Harris Trust and Savings Bank v. John Hancock Mutual Life Insurance Co.*, 970 F.2d 1138, 1140 (2d Cir. 1992).

[31] *Id.* at 1141.

[32] *Chevron U.S.A. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

> [t]he judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent. . . . If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect.[33]

It is clear beyond a doubt that Congress did not intend to provide a blanket exception from the fiduciary duties provisions of ERISA for assets in insurance company general accounts, which is the practical effect of the position taken by the DOL in its *amicus* brief. Congress clearly was familiar with general and separate accounts and clearly knew how to fashion an exemption that would have excluded all general account assets from ERISA regulation. In fact, such an exemption had been considered, had been included in the Senate version of the bill, and was abandoned. It is inconceivable that Congress would have coined a new term, "guaranteed benefit policy," to mean nothing more than a policy or contract funded through general account assets.

Therefore, the DOL's position is contrary to the clear intent of Congress and cannot control, and it should not be given any deference.[34]

b. The Department's Position Is Not a Permissible Interpretation of the Statute.

Even if the DOL's position were not so clearly contrary to the intent of Congress, it would not be entitled to deference because it is not a "'permissible' construction . . . that is 'rational and consistent with the statute.'"[35]

[33] *Id.* at 843 n. 9 (citations omitted).

[34] *Chevron*, 467 U.S. at 842-43 ("the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.")

[35] *PBGC v. LTV Corp.*, 496 U.S. 633, 650 (1990) (citations omitted).

As demonstrated above Congress in Section 401(b)(2) did not create an exception to ERISA fiduciary regulation with respect to all assets held in an insurance company general account. The plain and unambiguous language of that section provides an exemption from regulation under Part 4 of ERISA which is limited by the "to the extent" language. It is further limited by the reference to "benefits," which both the DOL and the Petitioner would correctly give a narrow meaning. The ERISA Conference Committee's explanation of the exception found in Section 401(b)(2) makes it crystal clear that, in limiting the exception by use of the "to the extent" language, Congress intended that insurance policies and contracts would, in fact, be bifurcated for purposes of applying the fiduciary rules of ERISA. The Committee gives, as an example of how Section 401(b)(2) is to be applied, a *single* policy with a guaranteed portion and a nonguaranteed ("variable") portion and states, in no uncertain terms, that only the guaranteed portion would be excepted from the fiduciary rules and that the other portion would be subject to those rules.[36]

It also is clear that the Committee was not referring to a policy under which part of the assets are invested in a general account and part of which are invested in a separate account, because it explained in the next paragraph how separate account assets are to be treated.[37] Finally, the Department's surmise that the Committee intended the term "payments" to refer only to benefits paid to individuals, DOL *amicus* brief at 21, is contradicted by the fact that the Committee distinguished between "basic payments," which were guaranteed, and "other payments" which varied with investment performance. Inasmuch as the Committee was describing payments made under one single policy, it is more likely that it was using "basic payments" to mean benefits paid to participants or beneficiaries and "other payments" to mean payments made to the plan.

The logical result of the construction favored by Hancock and its *amici*, including the DOL, would be that an insurance contract

[36] H.R. Cong. Rep. No. 1280, 93d Cong., 2d Sess. 296 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5077.

[37] *Id.* at 296-297.

would be deemed a "guaranteed benefit policy" and the insurer would escape ERISA fiduciary regulation, if the contract was designed (by the insurance company) to include some minimal element of guarantee regarding plan benefits. Indeed under these constructions, a contract, through which a plan commits millions of dollars to an insurance company for management, would be a guaranteed benefit policy if the benefit of only one participant was guaranteed.

It is undisputed that ERISA is a remedial statute designed to protect participants and beneficiaries and their plans.[38] Exceptions to ERISA's protective provisions, such as the exception found in Section 401(b)(2), must be construed narrowly.[39]

Congress recognized this long-standing rule of construction and intended it to be applicable to ERISA. "It is intended that coverage under the Act be construed liberally to provide the maximum degree of protection to working men and women covered by private retirement programs. Conversely, exemptions should be confined to their narrow purpose."[40] The DOL's application of Section 401(b)(2) would turn this traditional and congressionally mandated rule of construction on its head. It would replace a rule which looks to the substance of a policy or contract with one that looks only to form. The fact that Congress adopted a standard which is not a bright line test, but which, instead, requires a careful examination of the policy or contract in question, does not make the statute ambiguous and does

[38] *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 90 (1983) ("ERISA is a comprehensive statute designed to promote the interests of employees and their beneficiaries in employee benefit plans" (citations omitted)). It is clear, as the DOL has stated on numerous occasions, that, in creating ERISA, the intention of Congress was (1) to protect participants and beneficiaries of employee benefit plans by, among other things, establishing strict fiduciary standards for the investment of plan assets and (2) that managers of pooled investment vehicles to whom plan assets are given are to be subject to those standards. *See, e.g.*, proposed revision to plan asset regulations, 45 Fed. Reg. 38084 (June 6, 1980).

[39] *A.H. Phillips, Inc. v. Walling*, 324 U.S. 490, 493 (1945)(holding that an exemption from a remedial statute is to be extended only to "those plainly and unmistakably within its terms.")

[40] S. Rep. No. 93-127, 93d Cong., 1st Sess. 18 (1973), *reprinted in* U.S.C.C.A.N. 4838, 4854 (1974).

not give the DOL license to substitute a standard which is easily applied, but which deprives plans and their participants and beneficiaries of protections established by Congress. Such a construction[41] would be an unacceptable "abuse [of] the interpretive process." [42]

Therefore, in keeping with the remedial purposes of ERISA, congressional intent that exceptions to its remedial provisions be read narrowly, and the longstanding rule of statutory construction, the exception contained in Section 401(b)(2) must be read narrowly to apply to assets held by insurers under contracts or policies issued to ERISA plans only *to the extent* benefit payments to participants and beneficiaries are guaranteed. To the extent such policies or contracts also act as investment vehicles for plans, the assets must be subject to the protections afforded by ERISA.[43]

[41] The DOL's "interpretation" expressed in its *amicus* brief is more properly characterized as legislative regulation (even though it did not follow the required regulatory process in developing the interpretation). And, although on occasion Congress leaves it to an agency to fill in statutory gaps, such is not the case here. Moreover, even if serious difficulties were presented by the reasonable application of Section 401(b)(2), a solution should be fashioned by Congress. It is clear that the DOL has had and still has a great deal of difficulty understanding the practices of the insurance industry. And well it should, these practices are very complicated and ever-changing. *See* note 43 below. This is not an issue that should be resolved through an ostensible interpretation.

[42] *A.H. Phillips*, 324 U.S. at 493.

[43] As the Court of Appeals for the Seventh Circuit correctly concluded, many contracts which are funded by general account assets and which "provide for" the possibility of securing guaranteed annuities are little more than variable investment vehicles. *Peoria*, 698 F.2d at 327. As described in a leading text, Dan M. McGill and Donald S. Grubbs, *Fundamentals of Private Pensions* 492 (6th ed. 1989): "Life insurers offer certain contractual arrangements that do not contemplate the purchase of annuities for vested or retired employees and are designed to be purely investment vehicles for pension plan assets. The assets under these contracts may be held in the general account of the insurer or in one or more separate accounts." (This statement flatly contradicts the proposition for which this text is erroneously cited by *amicus* ACLI. ACLI *amicus* brief at 9 and n.8.) Moreover, in Everett T. Allen, Jr., Joseph J. Melone and Jerry S. Rosenbloom, *Pension Planning* 228 (5th ed. 1984), the authors discuss the complicated evolution of insurance products for pension plans, including the IPG type of contract at issue here, noting that an IPG contract involves "a further reduction in insurer guarantees and the immediate reflection of actual [investment] experience under the plan. . . ."

B. THE RULING BELOW WILL NOT BE UNDULY DISRUPTIVE FOR PLANS OR THE INSURANCE INDUSTRY.

The dire consequences of the ruling below which are predicted by the Petitioner and its *amici* unravel upon examination. Two principal concerns are expressed: one focusing on the impact of the prohibited transaction provisions and the other focusing on the "solely in the interest/exclusive purpose" requirements of Section 404. Both concerns are illusory.

As is discussed above, the DOL has the authority to grant exemptions from the prohibited transaction provisions. It has exercised this authority numerous times in a wide variety of circumstances. For example, among the exemptions it has issued is a class exemption covering pooled investment accounts of insurance companies, which came in response to a request submitted by the Petitioner and the ACLI, among others.[44] The difficulties which this exemption is designed to address are the very same difficulties listed by the Petitioner and its *amici*, *i.e.*, large numbers of investors, thousands of parties in interest, and thousands of transactions that would be technical prohibited transactions.

There is no reason why the DOL cannot fashion a prohibited transaction exemption, with retroactive as well as prospective effect, which addresses the concerns of the industry and provides necessary protections for plans and their participants and beneficiaries.

The second professed concern is equally contrived. The Petitioner and its *amici* assert that, if assets in a general account are held to be plan assets, insurance companies will be required by the fiduciary rules of ERISA to favor ERISA plan contract holders over non-ERISA plan contract holders. However, the practice of the industry with respect to pooled separate accounts contradicts this assertion.

For years, insurance companies have maintained pooled accounts containing the commingled plan assets of many employee

[44] 42 Fed. Reg. 54886 (Oct. 11, 1977).

benefit plans subject to regulation under ERISA.[45] The insurance companies are fiduciaries with respect to each plan in a pooled account. Although the plans share certain identical interests with respect to the assets in a pool, each plan also has its own separate needs and interests, which may conflict at times with the general interests of all of the plans.[46] However, no one has ever suggested that the insurance company faces an irreconcilable conflict of interest because it owes separate Section 404 "solely in the interest" duties to each plan. It is a given and it is understood that the insurance company's duty is to look after the collective interests of all of the plans. The insurance company would not be required to favor the individual interests of one plan over another. The insurance company, however, would not and should not be able to favor itself over a plan investor. Neither the Petitioner nor any of its *amici* have demonstrated that a similar analysis would not be appropriate with respect to the management of general account assets subject to ERISA regulation.

Moreover, if the insurance industry has developed investment vehicles which indeed create real irreconcilable conflicts between investors, assets can and should be segregated. The industry should not be allowed to develop products which seemingly create conflicts under ERISA and then be heard to argue that ERISA should not be applied because it would be difficult to resolve the problems the industry has created.[47]

Finally, in all candor, the Petitioner and its *amici* must admit that the insurance industry, as we know it, has not collapsed in disarray in the Seventh Circuit, where the ruling below has been the

[45] *Id.*

[46] For example, one plan might find itself with an immediate cash flow problem at a time when it would be disadvantageous for the other plans to liquidate investments in the pool.

[47] Indeed, the history of the insurance industry has been marked by a remarkable adaptability to the pressures of the marketplace which have caused it to alter the nature of its general account products in fundamental ways to meet demands for flexibility in benefit design and for participation in investment experience. Allen, Melone and Rosenbloom, *supra*, at 207-30; McGill and Grubbs, *supra*, at 492 ("[l]ife insurance companies compete head-on with banks and trust companies for the management of pension plan assets.") Moreover, such adaptation has

(footnote continued on next page)

law for a decade. It is also noteworthy that the supposed conflicts which the insurance industry claims are the source of its concern here were not made an issue in *Peoria*. The issue in *Peoria*, and the real issue here, is potential self-dealing by insurance companies for their own benefit. The Seventh Circuit recognized that fact in *Peoria* and recognized the importance of giving full effect to the protections incorporated into ERISA by Congress. It is equally important to give effect to those protections here.

C. THE INSURANCE INDUSTRY HAS BEEN WELL AWARE OF THE LIMITED SCOPE OF SECTION 401(b)(2) AND THE LIMITED EFFECT OF IB 75-2.

From the beginning, the insurance industry has been aware of and concerned about the impact of ERISA fiduciary responsibility standards, particularly on its general account operations. This concern was well-justified as the industry was also aware that Section 401(b)(2)'s guaranteed benefit policy exception was too narrow to accommodate all of the varied products issued under insurer general accounts. Therefore, it continually lobbied for a satisfactory legislative or regulatory solution tailored broadly to exclude all general account contracts. These attempts have been properly unsuccessful.

ERISA, as finally enacted in 1974, did not contain the specific exception for general account assets that had appeared in the Senate bill. DOL *amicus* brief at 20. Shortly thereafter, when the American Life Insurance Association (ALIA), the predecessor to ACLI, assigned a task force to study various aspects of ERISA, it was forced to conclude that "[w]hile it is clear that assets in a separate account would be treated as 'plan assets' under this provision, it was agreed

required the cooperation and approval of the state insurance regulators. *See id.* at 494 ("momentous step" of creating separate accounts under state insurance laws for pension plan customers done under "authority of special legislation or administrative interpretation of existing law"). There is no reason to believe that the industry, with the assistance of state insurance commissions, will not bring to bear the same resourcefulness in meeting the fiduciary responsibilities imposed by the reasoning of the Second Circuit below.

that it is not clear what types of policies based on the general account (if any) would cause general account assets to be similarly treated."[48] In light of this virtual concession that not all general account contracts may be guaranteed benefit policies, it was agreed that ALIA would seek a general ruling exempting general account assets from the prohibited transaction rules.[49] This approach was preferred over "arguing that all policies are 'guaranteed benefit' policies"[50] presumably because of the difficulties presented by such an argument.

After the prohibited transaction exception of IB 75-2 was obtained, ACLI convened a meeting in 1976 to discuss the need for legislative relief specifically exempting general account assets for all purposes, describing the necessary language as follows:

> "[t]he assets in an insurance company's *general asset account* will not be considered 'plan assets,' and the insurance company, thus, will not be considered a plan fiduciary by reason of managing those assets, for any employee benefit plan holding contracts based on that account."

(emphasis in original).[51] Such a legislative amendment "was thought desirable by the [ACLI] in light of the questionable rationale of the Government ruling [*i.e.*, IB 75-2] and the contention by some employers that it may not withstand a legal challenge."[52] However, no such legislative relief was forthcoming.

ACLI's Pension Committee met again, in October 1979, to discuss the continuing problem of general account treatment under ERISA. This time ACLI discussed ways to revise the DOL's recently

[48] ALIA Minutes, dated September 18, 19 and October 2, 1974. Append. A-8

[49] *Id.* Append. A-8 It is noteworthy that ALIA's focus here is consistent with the proper interpretation of IB 75-2 as limited to prohibited transactions.

[50] *Id.*

[51] ACLI Minutes, dated September 16, 1976. Append. A-16.

[52] *Id.* Append. A-17.

proposed plan asset regulations. Specifically, the Committee discussed how "[t]he regulations should be revised to make clear that, in the case of a plan funded with a contract or policy of insurance, plan assets do not include the underlying assets in the insurance company's general account, whether or not the contract insures plan benefits."[53] As this discussion makes clear, the industry remained insecure in 1979 about the extent of protection offered by ERISA and IB 75-2. Of course, the reference in the above quoted language to general account contracts, which do not even insure benefits, discloses the source of the industry's insecurity: contrary to the theme that runs through the briefs of Hancock and various *amici*, general account contracts, as noted elsewhere,[54] can be nonguaranteed or variable in many respects even with respect to benefits.

Indeed, it appears to be the industry's inability to give adequate assurances to the DOL regarding the nature of general account contracts which led to the defeat of its next major campaign for legislative relief. Beginning in late 1983 after issuance of the *Peoria* decision, the ACLI again revisited the perennial problem of fiduciary coverage of general account assets:

> As you are all well aware, ever since the enactment of ERISA, there has been concern regarding the treatment of general account assets and the potential application of ERISA's fiduciary responsibility provisions and prohibited transaction rules to these assets .... [S]ome companies believe that unless some action is taken quickly, either legislative or regulatory or a combination of both, the issue will be decided adversely to the industry."[55]

Consequently, in 1984 and 1985, industry representatives made formal submissions to the DOL and held a series of meetings with

[53] ACLI Pension Committee Memorandum, dated October 16, 1979. Append. A-26-27.

[54] *See* notes 43, 57 and 58 and accompanying text.

[55] ACLI Letter to Task Force on Fiduciary Matters, dated December 16, 1983. Append. A-39.

DOL representatives.[56] The written submission made in March 1984 described general account contracts as involving the credit of "interest and other amounts, such as dividends or rate credits, that *to some extent* were expressly guaranteed and *to some extent* left to the discretion of the insurer based on its investment and mortality experience" (emphasis added)[57] The submission went on to note that "[b]ecause many of these contracts provide for varying degrees of participation by the contractholder in the investment, mortality, or expense experience of the insurer, few of the contracts can factually be said to be totally 'guaranteed.'"[58]

It should have been no surprise when the DOL's response was not overwhelming. By letter dated June 1, 1984, the DOL informed ACLI that it was not prepared to support legislation dealing with the general account issue, citing the need for further information regarding the nature of the general account products issued by the industry.[59] The industry, therefore, continued to press the matter and another formal meeting with DOL representatives was held on March 5, 1985.

The clear focus of this meeting, from the DOL's point of view, was the nature of general account policies with particular emphasis on the payments made to the plan under such policies. For example, a DOL representative asked whether general account policies always

[56] ACLI Letter to Pension Committee, dated March 22, 1984, attaches the submission (DOL Submission) and shows a March 23, 1984 meeting with Secretary of Labor Donovan and others. Append. A-41. ACLI Memorandum, dated April 19, 1984, Append. A-70, speaks of a meeting with DOL staff. ACLI Memorandum of March 5, 1985 meeting with DOL staff. Append. A-82-85. ACLI Memorandum, dated October 9, 1985, Append. A-94, refers to another meeting with DOL staff.

[57] DOL Submission. Append. A-47. The language used bears a striking similarity to the "to the extent" language of the guaranteed benefit policy definition; even the industry has acknowledged, in moments of candor, that general account contracts are guaranteed only in part.

[58] *Id.* Append. A-49.

[59] Letter from Robert A.G. Monks, Administrator of the DOL's Office of Pension and Welfare Benefits Programs to ACLI, dated June 1, 1984. Append. A-81.

guaranteed principal and interest.[60] Another question went to whether:

> it was possible for an insurance company to issue a general account contract that would provide nothing more than the policyholder's participation in a pro rata portion of the investment performance of a particular segment [of the general account], such that the contract would operate no differently than a separate account contract.[61]

The hedging response of the industry representatives was not particularly reassuring:

> We initially indicated that our survey did not reveal that this type of contract was being offered by an insurance company. Secondly, we indicated that it might be disadvantageous or impossible to offer such a product because of tax or state insurance considerations.[62]

The DOL's reaction to this meeting was definitive. As the ACLI described it:

> the Labor Department has rejected our legislation and has suggested instead that legislation be drafted that would: (1) treat general account contracts similar to any other investment a plan makes so that a determination would have to be made as to whether a plan which purchases a general account contract is purchasing a debt or equity interest; and (2) require insurance companies to disclose to a prospective purchaser the key features of the contract he is interested in purchasing including, among other things, a description of what would happen upon a premature termination of the contract.[63]

Therefore, in 1985, the insurance industry was highly insecure about the regulatory and legislative treatment of general account assets. Far

[60] ACLI Memorandum of March 5, 1985 meeting with DOL. Append. A-83.

[61] *Id.* Append. A-85.

[62] *Id.*

[63] Letter from ACLI to General Account Legislative Strategy Group, dated May 17, 1985. Append. A-86.

from the broad exemption the industry claims to have consistently relied upon, it was faced in the mid-1980s with a Department that advocated application of the general plan asset test to general account contracts. Moreover, the DOL was inclined at the time to require special disclosures to plan sponsors about the contract termination provisions that are so often the subject of fiduciary breach actions against insurers.[64]

Understandably, the industry continued to work for legislative relief, which it had been told could not be accomplished without support from the DOL. To achieve its goal, ACLI attempted to draft legislative language that would accommodate the DOL's concerns. ACLI described those concerns as including:

> [A] serious concern that any broad exemption of insurance company general account operations from ERISA should not leave employee benefit plans without a federal right to seek consequential damages in the event of an insurance company's commission of fraud or an insurance company's abuse of its discretion to unilaterally amend or otherwise modify the provisions of its contracts. Additionally, the staff has implied that its willingness to support a broad based exclusion of general account assets from 'plan assets' status might be conditioned upon the application of a prudence standard to an insurance company's investment of consideration under a general account contract to the extent that the contractholder participates in the company's investment experience.[65]

However, even ACLI's attempts to obtain modified legislative relief encountered insurmountable congressional resistance.[66]

[64] *See, e.g.*, *Jacobson v. John Hancock Mutual Life Ins. Co.*, 655 F.Supp. 1290, withdrawn pursuant to settlement, 662 F.Supp. 1103 (D. Conn. 1987).

[65] ACLI Memorandum regarding Description of Modified ERISA Legislation, dated June 28, 1985. Append. A-88-89. Such a prudence standard is essential for contract holders, like Harris Trust, who clearly participate in the investment experience of Hancock.

[66] ACLI Memorandum, dated October 9, 1985. Append. A-94-95.

Consequently, by March 1986, ACLI conceded that any attempt to obtain "comprehensive general account" legislation should be put on hold.[67]

As the above history discloses, contrary to its current claim, since enactment of ERISA and the issuance of IB 75-2, the industry has *not* conducted its affairs confident in the belief that ERISA did not reach general account assets. To the contrary, the industry has been engaged in an almost continual effort to obtain a real exemption from ERISA scrutiny of those assets, knowing from the beginning how precarious its current position has been. There are no settled expectations here because the law has never provided a wholesale exemption for general account assets and the regulators have always been ambivalent at best and hostile at worst to the industry's entreaties in this regard. Indeed, with the opportunities presented by an almost twenty year transition period, the insurance industry should be well prepared to deal with the dislocations that have been a natural part of adaptation to ERISA's requirements for all other segments of the economy.

[67] ACLI Memorandum, dated March 4, 1986. Append. A-109.

CONCLUSION

For the reasons set forth above, the Western Conference of Teamsters Pension Trust Fund respectfully urges the Court to affirm the decision of the court below, apply the exception under Section 401(b)(2) narrowly, and hold that, to the extent a plan can share in the variable experience of an insurance company general account pursuant to an insurance contract or policy, the insurance company is acting as an ERISA fiduciary.

Respectfully submitted, July 9, 1993.

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APPENDIX A

MINUTES OF THE MEETINGS OF THE PENSION COMMITTEE HELD AT THE ALIA OFFICES, WASHINGTON, D.C., ON SEPTEMBER 18 AND 19 AND OCTOBER 2, 1974

Subjects Covered — Page

The meetings were convened at 1:30 p.m. on September 18 and continued on September 19 and October 2.

The following members were present at one or more of these sessions:

Doug Hunter, *Chairman*
Verne Arends
Larry Brossman
Frank David
Richard Higgins
A. Charles Howell
Dave Hurd
John McCoy
Robert Pease
William Prouty
Gerald Randall
Donald Willard
John Williams

The following members were unable to attend:

Edward Blakesiee
Harry Bubb
Howard Hennington
Daniel Kubik
Richard McLoughlin

Others present were:

Harry Blair — Metropolitan
Lawrence Brown, Jr. — Provident Mutual
George Burke, Jr. — Mass Mutual
A. Donald Champagne — Aetna Life & Casualty
Douglas Clark — Connecticut Mutual
Bill Culningham — Pacific Mutual
Edward DeGroff — Connecticut Mutual
Grace Dillingham — ALIA
Joseph Garner — Mass Mutual
William Gibb — ALIA
Herbert Gindlin — Home Life
William Heller — TLAA_CREF
W. Holmes — Aetna Life & Casualty
William Hust — Travelers
Steve Kraus — ALIA
Bob Mallory — Connecticut General
Al Moses — Connecticut General
Bruce Nickerson — ALIA

Carl Ohman — Equitable Life Assurance
Donald Pond — Connecticut Mutual
George Powell — Prudential
Jeanne Cullinan Ray — MONY
Tom Shea — Connecticut General
John Stiefel — Aetna Life & Casualty
Thomas Sullivan — Aetna Life & Casualty
Christopher Wain — Prudential
Bill Wellette — Connecticut General

The primary purpose of the meetings was to receive and act on the reports of the Committee's five task forces which had been reviewing the provisions of the newly enacted "Employee Retirement Income Security Act of 1974". In each case, the task force report set forth problem areas raised by the new law which the task force believed were in need of resolution by Government regulations or rulings and, where appropriate, the task force suggested solutions. On the basis of the recommendations in these reports and suggestions raised by Committee members, the Committee decided on those issues which should be raised by the ALIA as first priority items and instructed the staff to take appropriate action to bring these matters to the attention of the appropriate Government personnel charged with writing the regulations under the new law.

The following is the action taken by the Committee on each task force report:

I. Report of Task Force No. 1—Eligibility and Vesting.

Don Willard (Chairman) presented the Task Force Report (a copy of which is attached to these minutes). The following action was taken by the Committee:

(A) Comment I of Task Force Report. The Committee agreed with the suggestion in substance and decided that a regulation should be sought indicating that a plan may defer an employee's eligibility for ancillary benefits under a plan (such as a life insurance protection) beyond the age and service limitations set forth in the new law as the general eligibility requirements for pension coverage.

(B) Comments II, IV and V. The Committee agreed with the recommendations of the Task Force contained in these comments and decided that appropriate regulations should be sought.

In addition to the matters raised by the Task Force, the Committee decided that the following items should be covered by early regulations:

(1) It should be made clear that the new rules defining the amount of "accrued benefits" which must be payable to a terminated employee with vested rights are not applicable to an employee who terminated service before the effective date of the new vesting provisions.

(2) The regulations should clearly delineate the type of benefits that are subject to the new vesting standards. For example, the regulations should make clear whether a plan must vest a benefit in excess of the value of a straight life annuity—i.e., a term certain feature or a spouse's benefit payable on death after retirement.

II. Report of Task Force No. 2—Funding.

Charles Howell (Chairman) presented the report of the Task Force (a copy of which is attached to these minutes). Mr. Howell noted that the Report was intended as a more or less comprehensive listing of areas where Government clarification would eventually be needed, but that only certain of the items seemed to call for immediate action.

The Committee decided that the following items in the Report should be presented by the ALIA as first priority matters for regulations:

(A) Definition of "Current Value" (pp. 3-5 of the Task Force Report). The Committee, in agreeing with the basic Task Force recommendations, decided to request a regulation indicating that:

(1) For a wholly or partially insured plan, the insurance or annuity contracts (and not the insurance company's underlying

assets) will be considered as plan assets for funding purposes; and

(2) The value of such contracts will be determined by the actuary under any reasonable actuarial method.

(B) Acceptable Actuarial Cost Methods (pp. 5-6 of Task Force Report). The Committee agreed with this recommendation relating to the allowance of terminal or pay-as-you-go funding for certain incidental benefits (such as disability benefits). Mr. Howell was asked to compile a list of the type of benefits that would be included in the "incidental" category for use in discussing this matter with the Government, although it was agreed that it would be preferable, for regulation purposes, to define the benefits covered in the incidental category in terms of a percentage of total plan costs rather than attempting to list them benefit-by-benefit.

(C) Exclusion From Funding Requirements for Certain Insured Plans (pp. 7-9 of Task Force Report). The Committee agreed to request regulations on the following two matters discussed in this section of the Task Force Report, which generally relates to the statutory exclusion from the funding requirements for plans funded exclusively by level premium individual policies or by group insurance contracts having the same characteristics:

(1) A more precise definition of the group contracts that will qualify for the exclusion. Jeanne Ray (MONY) and Dave Hurd (Bankers of Iowa) were asked to draw up a draft of such a regulation.

(2) A provision indicating that a so-called flexible premium contact, under which additional benefits may be purchased with a step_up in the premium on a level basis, qualifies as a level premium policy for purposes of the above-cited statutory exclusion. It was noted that the use of such a policy is substantially the equivalent of funding additional benefits (for example, those resulting from an increase in compensation) through the purchase of additional level premium policies, which clearly qualify for the exclusion.

III. Report of Task Force No. 3—Disclosure and Fiduciary Standards.

Frank David (Chairman) presented the Report of the Task Force (a copy of which is attached to these minutes). The following

action was taken by the Committee on the various recommendations in the Report.

(A) Reporting and Disclosure (Section I of the Report).

(1) Item 1(a) relating to method for reporting benefits purchased from an insurance company on the plan's financial statement. The Committee adopted the recommendations included in a Supplementary Report of the Task Force presented at the October 2 meeting (a copy of which is attached to the Task Force Report) which was prepared as a result of Committee discussion on September 18.

(2) Item 1(b) regarding the valuation of insurance contracts. The Committee decided that a regulation should be sought adopting the same valuation rules as are being proposed under the funding provisions (see Item II (A)).

(3) Item 1(c) relating to the reporting requirements that should be applicable to fully insured plans. The Committee agreed with the Task Force that fully insured plans should be exempted from a number of the reporting requirements, and requested the staff to work to this end in discussions with the Labor Department recognizing that the specific rules will depend to a great extent on the approach being taken by the Department in developing new reporting forms.

(4) Item 2 relating to the reporting requirements for Welfare Benefit Plans. It was reported that this matter would be considered by a task force of the ALIA Group Committee. [Note: Subsequent to the meetings, such a Task Force was appointed, comprised of George F. Hockney (John Hancock), Richard J. Mellman (Prudential), and H. Morgan Spencer, Jr. (Travelers).]

(5) Items 3, 4, 6, 7, 8, 9 and 10. The Committee agreed that the recommendations set forth in these items should be presented to the Government.

(6) Item 5 relating to designation of an enrolled actuary for insured plans. The Committee decided that this matter should more appropriately be dealt with by the actuarial organizations.

(B) Fiduciary Standards

(1) Item I — Definition of Fiduciary. The Committee considered both the report of the task force, and a report of a supplementary task force (chaired by Larry Brossman) which had been formed to focus particularly on the possible impact of the new fiduciary provisions on insurance companies and agents resulting from their activities in connection with the installation and servicing of retirement plans. (The report of the supplementary task force was distributed to the Committee.)

After considerable discussion, the Committee decided that the ALIA should request the Labor and Treasury Departments to take immediate action to make clear that the new law is not intended to disrupt the normal business activities of insurance agents (including the receipt of commissions). To this end, it was agreed that the following two specific administrative regulations or rulings should be sought:

(a) That the offering of a product or alternate products of a life insurance company or companies and related affiliates for sale by an agent or broker (whether or not offered with products of other funding media) does not constitute the giving of investment advice (so as to classify such an agent or broker as a "fiduciary" within the meaning of section 3(21)(A) of the new law) provided the agent or broker makes known that he will receive compensation for the sale of such product or products.

(b) That the receipt of commissions under normal insurance company compensation schedules by an agent or broker who is considered a plan fiduciary shall not constitute a prohibited transaction, provided that full disclosure of such commission payments is made to the employer or plan trustee.

It was left to the discretion of staff to determine the most feasible way to obtain these results (i.e., by regulation or perhaps partially by regulation and partially special exemption). A task force, consisting of Don Champagne, Chairman, (Aetna), Joe Garner (Mass Mutual) and Jim Wilson (New England Life), was appointed to prepare the

submission on item (b) above, relating to the receipt of commissions by agent-fiduciaries.

(2) Item 2 — Treatment of an insurance company's general account as "plan assets". Under section 401 (b)(2) of the new law, the assets of a life insurance company underlying an insurance contract issued to an employee benefit plan are to be considered as assets of the plan, except if the contract "provides for benefits the amount of which is guaranteed by the insurer". While it is clear that assets in a separate account would be treated as "plan assets" under this provision, it was agreed that it is not clear what types of policies based on the general account (if any) would cause general account assets to be similarly treated. However, if it is eventually decided that at least some types of policies would have this effect, it was the overwhelming consensus of the Committee that treating general account assets as "plan assets" in these situations would severely disrupt the investment operations of life insurance companies. This would result primarily from the fact that, under the prohibited transaction rules, the life insurance company would be prohibited from dealing with respect to the general account assets with any person connected with an employee benefit plan holding such a policy. For example, under these restrictions, the insurance company could not lend moneys to an employer corporation with such a plan underwritten by the company.

In view of these potential problems the Committee decided that the ALIA should seek a general ruling under the applicable provisions of the bill exempting the general account assets of an insurance company from the prohibited transaction rules. The Committee decided that this approach would be preferable to arguing that all policies are "guaranteed benefit" policies. In this regard, it was agreed that the requested exemption should also cover transactions of a commingled separate account with parties in interest with respect to an employee benefit plan whose interest in the commingled account does not exceed 10 percent of the total account. (See Item 6 of the Task Force Report.)

(3) Items 3, 7 and 8. The Committee adopted the Task Force recommendations contained in these items.

(4) Items 4 and 5. The Committee decided that no immediate action was necessary on these items.

IV. Report of Task Force No. 5 — Plan Termination Insurance and Miscellaneous.

Dave Hurd (Chairman) presented the Report of the Task Force (a copy of which is attached to these minutes). He explained that the Report was intended as a more or less comprehensive listing of problem areas, with the idea that not all of them required immediate ALIA action.

The Committee agreed that the recommendations contained in the following sections of the Report should be presented by the ALIA to the regulations writers:

(A) Joint and Survivor Annuity Provisions

(1) Section 205(a) (Page 2 of the Report) — It was decided to limit this recommendation (which relates to the requirement for explaining to employees the joint and survivor annuity provisions in the case of plans where an annuity form of payment is merely an option and not the regular form of distribution) to profit_sharing and thrift plans.

(2) Section 205(b) and (c) (Page 2 of the Report)

(3) Section 205(c)(1) (Page 3 of the Report)

(4) Section 205(e) (Page 4 of the Report) The Committee agreed with the substance of this recommendation which would permit a plan to require a lead time between the making of an election out of a joint and survivor annuity and its taking effect. However, as to specifics, it was decided that the ALIA should limit its request to a regulation which would allow a plan to provide that the election will not become effective for a specified period after it is made, not to exceed two years, and, in any event, must be made two years prior to normal retirement age.

(5) Section 205(g)(3) (Page 5 of the Report)

(6) Section 205(h) (Page 5 of the Report)

(7) As an additional item it was agreed that a regulation should be requested indicating that a plan will be considered as meeting the new pre-retirement survivor annuity requirement if it provides a spouse's benefit equal to at least a specified percent (perhaps 35 percent) of the employee's accrued benefit as of the time of death. Under such a provision, it would not be necessary to verify the actuarial value of the benefit at each age level. The specific percentage figure to be recommended will be such as will insure that the spouse's benefit will at least meet the statutory requirement in substantially all situations.

(B) Plan Termination Insurance

(1) Section 4006(a)(3) (Page 6 of the Report) While agreeing with the substance of this recommendation, which is aimed at simplifying the computation of the amount of the plan termination insurance premium, the Committee authorized staff to explore various alternatives with the Labor Department if the basic recommendation is not acceptable.

(2) Section 4006(a)(6) (Page 6 of the Report)

(3) Section 4041 (Page 9 of the Report)

V. Report of Task Force No. 4 — Tax Provisions.

Al Moses (Chairman) presented the report (including a supplemental report) of the Task Force (a copy of which is attached to these minutes). He explained that the Report was intended as a more or less comprehensive listing of problem areas, with the idea that not all of them required immediate ALIA action.

The Committee agreed that the recommendations contained in the following items of the report should be presented by the ALIA to the regulations writers:

Items 2, 6, 8, 11, 17, 21, 25 and 26.

With respect to item 13, relating to the method for valuing annuities under the lump-sum distribution provisions, it was agreed that the ALIA should offer to work with the IRS in developing regulations instead of initially proposing rules. It was felt that this approach would offer the maximum flexibility.

With respect to item 14, relating to the method for determining how fractional years are to be counted for purposes of applying the proration computation under the lump-sum distribution rules, it was agreed that the staff should emphasize the necessity for a simple rule (and offer various alternatives) instead of advocating only one particular approach as suggested in the report.

It was agreed that item 18, relating to clarification of the effective date of the new benefit limitations on corporate plans, should be handled informally with the IRS staff.

The meetings were adjourned at 5:00 p.m. on October 2.

MINUTES OF THE MEETINGS OF THE COUNCIL'S PENSION COMMITTEE HELD AT THE COUNCIL'S OFFICES, WASHINGTON, D.C., ON SEPTEMBER 16, 1976

The meeting was convened at 9:45 a.m.

The following members were present:

Douglas B. Hunter, Chairman
Verne J. Arends
Edward Blakeslee
Larry A. Brossman
Gilbert F. Cronin
Frank H. David
Harrison Givens, Jr.
Richard C. Higgins
A. Charles Howell
G. David Hurd
Harold G. Ingrham, Jr.
John S. McCoy
Richard W. McLaughlin
Robert W. Pease
William C. Prouty
Gerald J. Randall
Donald S. Willard, TLAA-CREF

The following members were unable to attend:

Glenn A. Mateja
John R. Williams

Others presents during all or part of the meeting were:

Lawrence R. Brown, Jr., Provident Mutual
George P. Burke, Jr., Mass Mutual
Harold Burke, IDS Life
Doug Clark, Connecticut Mutual
Arthur Fefferman, ACLI
Jack Forsythe, ACLI
Joseph Garner, Mass Mutual
William T. Gibb, ACLI
Bill Heller, TIAA-CREF
Bill Holmes, Aetna
John Jacobus, Equitable
John Joyce, State Mutual
Charles Kannel, New England Life
Steve Kraus, ACLI
Gordon MacKay, New England Life
Ken Maher, Aetna
Paul Mason, ACLI
Carl Meier, Bankers Life
Bruce Nickerson, ACLI
G. Robert O'Brien, Connecticut Genral
Ilbert Phillips, Occidental Life

Donald Pond, Connecticut Mutual
Jeanne Ray, MONY
Larry Rosenstein, ACLI
Gerald H. Sherman, AALU-NALU
Morgan Spencer, Travelers
Gerry Talbot, Metropolitan
Alfred A. Tucro, Phoenix Mutual
Chris Wain, Prudential
W. E. Wellette, Connecticut General
Kenneth White, ACLI
Stuart Yoffe, John Hancock

Legislative Program

Background. The Committee agreed that the implementation of the wide-sweeping provisions of ERISA has raised innumerable problems for the employee benefit plan community, including life insurance companies and their customers. Although the Council has addressed many of these issues at the Labor Department and Internal Revenue Service level, the Government Departments have been slow to react, not only to our problems, but also to those of employee benefit plans generally.

In this regard, the Committee agreed that ERISA provides at least some temporary protection in the fiduciary area (where most of the serious issues have arisen) through a limited grandfather clause, which is scheduled to expire on June 30, 1977. Some members noted that the coverage of this grandfather clause is, at best, debatable in some areas and, therefore, an extension should not be relied upon as a satisfactory solution.

In any event, in view of the imminence of the expiration date, particularly in the context of legislative possibilities, the Committee decided that it was imperative that the Council inventory the unresolved issues facing the life insurance business for the purpose of determining those which are of a "life and death" nature and decide on a course of action to resolve them.

To this end, each of the Committee's Task Forces had been requested to sort out the issues within its sphere, assign them

priorities, and where appropriate develop specific legislative language to resolve them.

Recommendations. The Committee received the reports from the Task Forces and, following discussion of the various recommendations, identified a series of proposals which it unanimously recommended form the basis for a Council Federal legislative program to be initiated as soon as possible consistent with regulatory developments. The proposed legislative package would have two basic components—

(1) An extension of the June 30, 1977, expiration date for the grandfather clause to December 31, 1979; coupled with

(2) Substantive legislative solutions to a series of problems.

This two-pronged approach was adopted in recognition of the belief by the Committee that, realistically, an extension is all that can be hoped for by mid-year (i.e., when the grandfather clause will expire). The Committee emphasized that the extension is not, however, a solution in itself, but should be considered as only a necessary prelude to provide time for the substantive solutions.

As for its substantive legislative package, the Committee recommended that the Council seek amendments to ERISA as follows (in each case, a short statement of the current status of the issue is included):

(a) Commissions and Services. The fiduciary provisions would be amended so as to permit an agent or broker to sell insurance company productsáor securities to an employee benefit plan and receive a commission therefore, notwithstanding his status as a party-in-interest or fiduciary to the plan. This would be accomplished through a series of three amendments to ERISA —

(i) Elimination of mere service providers from the category of persons who are considered parties-in-interest.

(ii) Permit fiduciaries (who are not insiders) to have multiple relationships with a plan (e.g., perform services, sell property, etc.) so long as such relationships are authorized by an independent fiduciary or the plan sponsor.

iii)Permit fiduciaries who are licensed life insurance or securities salesmen (and are not insiders) to represent an insurance company or other person in the sale of life insurance or securities to a plan and receive commissions therefor, subject to disclosure requirements and authorization of the purchase by an independent fiduciary or the plan sponsor.

Current Status: The Council, together with the AALU and the NALU, has an exemption application pending with the Labor Department and Internal Revenue Service which, if adopted, would permit agents and brokers of life insurance companies (other than "insiders") to sell insurance company products to an employee benefit plan, and receive commissions, despite their party-in-interest or fiduciary status. (It was reported that an amendment to the application was in the process of being filed to make clear that the exemption applies to nonfiduciary parties-in-interest.) Although the Council has been promised at least preliminary action early this fall, nothing definitive has happened yet. These transactions are, by administrative interpretation, presently covered, to a significant degree, by the grandfather clause.

(b) Selling vs. Investment Advice. The definition of "fiduciary" would be amended so as to make clear that selling activities, in connection with the marketing of insurance company products and securities, are not to be categorized as fiduciary activities (e.g., rendering investment advice).

Current Status: The Council, in conjunction with the AALU and NALU, has submitted to the Labor Department and IRS a request for an amendment to the regulations to reach this result for insurance company products. This project is joined with the exemption request described in item (a) above.

(c) Plan Assets. The fiduciary provisions would be amended to provide that:

(i) The assets in an insurance company's general asset account will not be considered "plan assets", and the insurance company, thus, will not be considered a plan fiduciary by reason of managing those assets, for any employee benefit plan holding contracts based on that account. The Committee decided against a Task Force recommendation that the legislation nevertheless allow the employee benefit plan to designate the insurance company as investment manager.

(ii) The assets in an insurance company's pooled separate account will not be considered "plan assets" except for employee benefit plans with a substantial interest in that account.

Current Status: The Labor Department and Internal Revenue Service have, in response to petitions by the Council and others, issued interpretative bulletins holding that general account assets are not "plan assets". The legislative amendment would codify this ruling—a move which was thought desirable by the Committee in light of the questionable rationale of the Government ruling and the contention by some employers that it may not withstand a legal challenge. It was noted that an IRS/Labor Department exemption, although legally more reliable, can deal only with the prohibited transaction provisions and not the general fiduciary status of the life insurance company.

On the separate account issue, the Council has an exemption application pending with the Labor Department and Internal Revenue Service, with indications that favorable action may be imminent. (It was noted that an amendment has recently been filed by the Council to meet objections raised by the Government staffs.) In this regard, it was noted that an exemption granted under the procedures established by ERISA does not carry the legal uncertainties associated with a ruling or regulation.

(d) New General Limitations. Although proposed regulations have not yet been published, it was reported that several issues have surfaced in connection with the IRS's implementation of the new overall limitations imposed by ERISA on the contributions or benefits that can be provided under qualified plans (section 415 of the Internal Revenue Code). The initial focus has been on master/prototype plans where the IRS is attempting to require various provisions in this area as a condition to granting approval.

To cure the most objectionable of these problems, the new limitation provisions would be amended —

(i) To make clear that the limitations (i.e., annual contributions to a defined contribution plan cannot exceed 25 percent of earned income, with a $25,000 maximum) are to be applied on an annual basis, and not cumulatively as each intra year contribution is made;

(ii) To provide that contributions, which turn out to be in excess of the limitations, may be returned in a reasonable period without penalty; and

(iii) To make clear that contributions for a year, which are made within the statutory grace period after the close of the year, are subject to the limitations for the year to which they relate.

Current Status: These issues are all in contest with the IRS, and the Council has endorsed a memorandum filed by two member companies on them. It appears that each of these issues can be solved at the IRS level, if the IRS is so inclined.

Discretion in Case of Administrative Action. The Pension Committee expressed its strong desire that the Council staff continue to vigorously pursue solutions to the above-described problems at the Labor/IRS level where appropriate. Moreover, it was recognized that timely administrative action may make legislation unnecessary in some, or possibly most, cases. Thus, the Committee recommended that the Chairman, in consultation with the appropriate Task Force Chairmen and Council staff, be given the discretion to modify the legislative program to reflect the current administrative situation on particular issues.

The Committee also requested the Task Forces to continue the process of developing and refining the specific statutory details and drafts of the agreed on proposals.

Other Issues. The Committee discussed at considerable length a recommendation that the Council's legislative package include an amendment to the Individual Retirement Account (IRA) provisions

to allow an individual to continue, on a non-tax preferred basis, to pay premiums on an IRA endowment contract after he loses his eligibility to participate in the IRA program. It was pointed out that under the present law, an individual may have to lapse his IRA endowment contract when he becomes ineligible to continue his IRA plan and that this would be particularly harsh in the early years of the contract. While acknowledging the defects of present law, several members were of the opinion that a legislative program on this matter at this time could produce a significant adverse reaction to some of the products being sold in the IRA market and, thus, might lead to restrictive legislation. Following the discussion, the Committee voted 9-6 against including this item in the legislative package.

It was reported that considerable pressure is beginning to build, even within the Government, for eliminating the areas of dual jurisdiction (Labor and IRS) created by ERISA. The Committee agreed that this dual jurisdiction is a significant factor in the delays that have resulted in implementing ERISA. On the other hand, the Committee recognized the political hazards inherent in backing one Department as against another. Following discussion, the Committee decided to take no position at this time, pending a clearer indication of possible solutions and the legislative climate. It was agreed that it would be most desirable if the lead on resolving this matter was taken by the Government.

The Committee recognized that there are other significant, but not "life and death", issues on which legislation should be sought if the opportunity arises, for example, a broadly sponsored ERISA bill is taken up in Congress. It requested the Staff and Task Forces to catalogue these issues for consideration by the Committee in the future.

Other New Business

Multiple Service Proposed Regulations. It was reported that the Labor Department and IRS had issued proposed regulations implementing several provisions of ERISA relating to the providing of services to a plan by a party-in-interest (including a fiduciary). The Committee was of the opinion that the basic framework of these proposed regulations represents a satisfactory solution to the multiple

service issues facing the life insurance business. However, it was agreed that several perfecting suggestions should be filed by the Council. [Comments were filed by the Council on September 23, 1976. See General Bulletin 2318.] Moreover, it was the clear consensus of the Committee that these proposed regulations do not, and are not intended to, deal with the ERISA problems involved in the sale of insurance company products to an employee benefit plan by an agent or broker who a party-in-interest, and the receipt of the commissions associated therewith. Thus, it was agreed that the Council's efforts on this matter at the administrative and possibly legislative levels must continue.

<u>Joint and Survivor Provisions.</u> It was reported that the Committee had been requested by Security Life of Denver to advocate certain positions as regards the application of ERISA's pre-retirement survivor annuity provisions. The request was referred to Task Force No. 6 for recommendations.

<u>Reports</u>

<u>Individual Retirement Accounts.</u> It was reported that the Internal Revenue Service has issued proposed regulations relating to disclosure statements for individual retirement accounts and annuities and that the requirements in these proposed regulations were much stricter than those in the temporary regulations which were issued last November and are presently in effect. The Committee was informed that the Council had filed comments regarding the proposed regulations with the IRS and that Chris Wain, Prudential, had testified on behalf of the Council at the public hearing regarding the proposed regulations. At the public hearing, the Council objected particularly to the elimination of the 7-day free look as an alternative to advance disclosure and to the requirement that sales commissions be disclosed. The Committee was further informed that the Subcommittee on Oversight of the Committee on Ways and Means was planning to hold a hearing on the subject of IRA disclosure and marketing and that the Council was invited to participate in order to describe the types of insurance and annuity contracts our member companies are marketing to fund individual retirement account programs. [The hearing was held on September 21, 1976, and Richard Minck, Chief Actuary, testified for the Council.]

It was also reported that the Tax Reform Bill pending in Congress contains two provisions that will affect IRA's. The first provision would increase, to $1750, the maximum IRA deduction for a family with an eligible worker and a non-employed spouse. The second provision will allow a survivor's interest in an IRA or an H.R. 10 plan to be excluded from a decedent's gross estate.

Finally, the Committee was informed that the Council had written a letter to the IRS requesting a modification of its reporting forms and procedures to recognize the fact that there will inevitably be some discrepancies between the amount of IRA contributions reported as having been received during a year by an insurance company (Form 5498) and the amount claimed as a deduction by the taxpayers (Form 5329). It was suggested to the IRS that a reconciling statement prepared by the taxpayer, with adequate substantiation, be accepted in the same manner as if the Forms 5498 and 5329 were in agreement.

<u>Plan Approvals.</u> It was reported that even though the Special Reliance Procedure expires September 30, the Service still maintains the position that Target Benefit Plans cannot be filed for approval. The Committee was informed that the problem has been discussed with an IRS representative, who apparently understands the problem and will attempt to solve it quickly.

A problem was raised concerning the amendment of defined benefit Subchapter S plans to conform to ERISA. It was suggested that the IRS extend the time limitations of the Special Reliance Procedure for these plans or issue regulations under section 401(j). The problem was assigned to Task Force No. 6 for consideration.

<u>Guaranteed Interest Contracts.</u> The Committee was informed that representatives of the Council were actively discussing the treatment of guaranteed interest contracts with the staff of the SEC. It was reported that the Council was attempting to obtain administrative relief from the Securities Laws but that a quick response was not likely. The Committee was further informed that legislative relief was not possible in this session of Congress.

The Committee also received a report by Charles Howell, Chairman of the Task Force on Actuarial Aspects of Valuation Problems. Mr. Howell reported that a draft proposal of the Task Force and the Council Actuarial Committee to increase the statutory valuation interest rates had been presented to the NAIC Technical Task Force on Valuation and Nonforfeiture Value Regulation at its meeting on August 18-19. The proposal, which would reduce required pension reserves for new business, had been favorably received by the NAIC Task Force. Specifically, it would increase the statutory valuation interest rate for newly purchased group annuities and single premium individual immediate annuities, for newly issued individual deferred annuities, and for newly issued life insurance. In addition to reducing required reserves for new business, the proposal would change the valuation standard for all group annuities purchased prior to the operative date of the NAIC 1972 Amendments to the Standard Valuation Law. At least one company was reported opposing this later change on the grounds that it would set a precedent for changing the minimum valuation standards for existing business. [At a subsequent meeting on September 21, the Council Actuarial Committee reversed its earlier decision on this part of the proposal and voted not to support any change in statutory standards for group annuities which are already in force.]

<u>Pension Benefit Guaranty Corporation.</u> The Committee was informed that the PBGC had developed draft specifications to be used in developing the regulations regarding the valuation of insurance contracts in terminating pension plans. It was reported that the draft specifications follow most of the Council's recommendations in this area. The Committee was further informed that Council representatives will shortly be meeting with the staff of PBGC to discuss these specifications, based on comments received from several members of the Committee.

It was further reported that the PBGC had modified its regulations governing the payment of premiums by adopting the "snapshot" approach (count participants as of the last day of the prior plan year) for computing the number of plan participants for premium payment purposes. Also, the PBGC modified the definition of "participant" to exclude a former employer with vested rights to immediate or

deferred benefits or a retiree who is receiving or is eligible to receive benefits from the plan if an insurance company has made an irrevocable commitment to pay the benefits to which the individual is entitled under the plan.

<u>Labor Department Advisory Council.</u> It was reported that the Advisory Council was considering whether it should recommend to the Labor Department that the requirement of Schedule A (Form 5500) that commissions be disclosed be eliminated. It was further reported that the Advisory Council has taken the position that the Labor Department's hours of service regulations are part of the Special Reliance Procedure and that it planned to tell the IRS that they should be so treated.

<u>Reporting and Disclosure.</u> The Committee was informed that there is still some confusion regarding the status of tax-sheltered annuities (section 403(b) plans) under ERISA. The Committee was advised by Doug Clark (Connect. Mutual) that the Labor Department is trying to develop rules for determining when a section 403(b) plan is <u>not</u> an employee benefit plan for reporting purposes. A similar issue is involved in IRA Plans. Mr. Clark was asked to represent the Committee in advising the Labor Department of the usual factual patterns, both the 403(b)plans and employer sponsored IRA's.

The Committee was further informed that various groups were working on simplifying the reporting requirements of ERISA. In this regard, the Committee was advised that Verne Arends had represented the Council at a hearing held by the Commission on Federal Paperwork. The Commission was advised of the tremendous increase in paperwork generated by ERISA and indicated that it would take action to try to ease the paperwork burden.

The next meeting was scheduled for November 16, 1976. The meeting was adjourned at 5:30 p.m.

MINUTES OF THE MEETINGS OF THE PENSION COMMITTEE HELD AT THE COUNCIL'S OFFICES, WASHINGTON, D.C., ON OCTOBER 16, 1979

The meeting convened at 9:30 a.m.

The following members were present:

G. D. Hurd, Chairman
William L. Cassidy
Gilbert F. Cronin
William Cunningham
Frank H. David
Joseph P. Garner
Harrison Givens, Jr.
Kenneth P. Hinsdale
Harold G. Ingraham, Jr.
Richard W. McLaughlin
William C. Prouty
Jeanne Cullinan Ray
Barry L. Shemin
Donald S. Willard
John R. Williams

The following members were unable to attend:

Larry A. Brossman
Marvin A. Levins
Stewart G. Nagler
Gerald J. Randall
Robert Shapiro
Dean A. Wahlberg

Others present were:

Melvin S. Altman, Equitable
Gerard M. Brannon, Council
George P. Burke, Jr., Massachusetts Mutual
Harold Burke, IDS Life
Chester Crabtree, Connecticut General
Ted Fleron, Insurance Company of North American
William T. Gibb, Council
William Heller, TIAA
John Jacobus, Equitable
Stephen W. Kraus, Council
Richard V. Minck, Council
Gregg Narber, Bankers Life
Ilbert Phillips, Council
Donald Pond, Connecticut Mutual
Francis X. Roche, New England Life
Gerard J. Talbot, Metropolitan
Chris Wain, Prudential
Judith Wolfson, Connecticut General

Report of Task Force on Fiduciary Matters

Gerard Talbot, Chairman, reported that the Task Force had met on September 14, 1979—a copy of the report regarding that meeting had been furnished to Committee members prior to this meeting—and on October 15, 1979. Mr. Talbot indicated that the Task Force had discussed (1) at the September 14 meeting, unfinished business with respect to obtaining ERISA prohibited transaction exemptions that the life insurance business needs and (2) at both the September 14 and October 15 meetings, proposed ERISA regulations relating to the definition of plan assets and the establishment of trusts to hold plan assets.

Mr. Talbot indicated that the Task Force reviewed an application for an ERISA prohibited transaction exemption filed by the firm of Groom and Nordberg on behalf of certain member company clients—which would allow insurance companies under certain circumstances to have discretionary authority to invest plan assets in (or transfer them between) various separate accounts and/or advisory accounts maintained or managed by that insurer without violating ERISA's prohibited transaction rules. The filing does not, however, request an exemption for the discretionary movement of funds by an insurance company between the general asset account and a separate account.

Mr. Talbot reported that the Council, pursuant to a Task Force recommendation and previous Committee approval, will also file an application—which parallels the previously mentioned application—for an ERISA prohibited transaction exemption for discretionary asset management.

Mr. Talbot also reported that the Task Force discussed the Department of Labor's (the Department) proposed ERISA regulations relating to the definition of plan assets and the establishment of trusts to hold plan assets and developed a proposed position for the Council to take on those proposed regulations: That position is as follows:

— The regulations should be revised to make clear that, in the case of a plan funded with a contract or policy of insurance, plan assets do not include the underlying assets in the

insurance company's general account, whether or not the contract insures plan benefits. Also, a possible negative inference should be removed (by eliminating the "notwithstanding" clause in section 2550.401b-1(d)) to the effect that "plan assets may arise in the general account if the contract does not technically qualify as "contract or policy of insurance".

— The regulations should make clear that the underlying assets of an equity interest in a partnership which develops or manages real estate should fall under the "operating company exemption" of the proposed regulations and, thus, should not be considered plan assets. If no relief is given, one can expect a reduction in real estate joint ventures between separate accounts and other persons because of the spectre of "fiduciary" status for the other persons. If the operating company exemption is not expanded to include the partnerships described above, the Department should be asked to at least exempt certain existing real estate partnerships from the new rules.

— The regulations should make clear that property securing a debt is not a plan asset. This would avoid the inference that beneficial ownership by a plan in such property makes such property a plan asset.

— The regulations should provide that employee contributions are not to be considered plan assets until they are paid over to a trust or insurance company, subject to a "reasonable" rule of three months. The proposed regulations take the position that employee contributions are plan assets when withheld from the employee's paycheck. There was discussion by the Committee on a variety of possible approaches the Council could take in dealing with this issue. Mr. Talbot stated that the question of when an item becomes a plan asset also directly relates to the issue of when a trust has to be established to hold that plan asset or when the item must be paid over to the insurance company. The Committee generally agreed that a "reasonable period of time" is needed for the employer to perform the functions necessary to compute

and pay over employee contributions and that a three week period is such a "reasonable period" that the Council should seek.

Finally, Mr. Talbot reported that the written report, submitted to the Committee prior to this meeting, contained recommendations regarding additional ERISA prohibited transaction exemptions the life insurance business needs and which should be requested by the Council (a copy of that portion of the report relating to those recommendations is attached to these minutes). There were no questions concerning these recommendations.

The Committee unanimously adopted the report and recommendations of the Task Force.

Report of the Task Force on Small Cases

Frank Roche, Chairman, reported that the Task Force had met on October 9, 1979 and was now seeking approval of the actions taken at that meeting. He indicated that the purpose of the meeting was to develop recommendations for incentives for encouraging employers to establish pension plans, including a suitable legislative approach (via S.209's Special Master Plan program) to permitting corporate employers to adopt certain master/prototype plans, and to operate such plans, without threat of IRS retroactive disqualification.

Mr. Roche reported that the recommendations which follow were developed at that meeting; and that the Task Force would continue to explore other recommendations, particularly, tax incentives.

(1) Improvement of Target Benefit Plan Benefit Limitations: Target benefit (or assumed benefit) plans should be subject to the defined benefit plan benefit limitations of Internal Revenue Code section 415 rather than, as at present, the Code section 415 limitation on contributions for defined contribution plans. This change would have the advantage of permitting target benefit plans to provide older employees, at the time of the plan's inception, with a benefit which takes into account past service (and thus might not be able to be funded under the annual defined contribution limitation) while retaining the defined contribution plan advantage of excluding the plan

from coverage under the plan termination insurance program. Moreover, the target benefit plan would be able to provide this greater benefit with more predictable costs for the employer than under a defined benefit plan since it is the participant's account balance that determines the actual benefit to be paid; therefore, the level of employer contributions is not subject to the plan's mortality or investment experience. Finally, since the target benefit plan is not a defined benefit plan, no actuarial certification is needed. This combination of factors would make target plans more marketable to small employers and thus contribute to the spread of coverage.

(2) Faster Amortization for Past Service Liabilities: ERISA would be amended to allow employers to fund past service liabilities, with the right to deduct contributions, under pension plans over a period of less than 10 years, rather than being limited to amortizing the liability—with appropriate deductions—no faster than over 10 years as under the current law. Permitting a faster amortization schedule, with deductions, would (i) provide employers with flexibility to match contributions and deductions with profitable years and, thusly, make adoption of a plan more attractive, and (ii) provide plan participants with the security of a more fully funded accrued benefit. Faster funding is a goal of ERISA and should be further encourage.

(3) Special Master Plan Provisions. The Special Master Plan Provisions of S.209 need improvement if they are to really serve as a vehicle for spreading pension coverage. To this end, the Task Force recommended that:

(a) The Council continue to pursue its recommendations presented to the Senate, which primarily involve a more careful delineation of the responsibility of the insurance company sponsor. Basically, such responsibility would be limited to reporting and disclosure.

(b) The Council urge the following additional changes in the S.209 version:

(i) No Retroactive Disqualification: The Special Master Plan should be immune from retroactive disqualification because of discrimination in operation.

(ii) Quinquennial Plan Amendments: A Special Master Plan should have to be amended and recertified only once every five years; consequently, a plan would be able to delay amendments needed in order to comply with new regulations published within five years of the date of the last certification.

(iii) Five Year or 4/40 Vesting: Five year vesting or 4/40 vesting would be a minimum vesting requirement, as a trade-off for the more liberal rules described in (i) and (ii).

After presenting the recommendations, Mr. Roche reported that at the Task Force meeting, a Task Force member reported that preliminary discussions had been held with Congressional staff on possible additional proposals to encourage expansion of plan coverage. The Congressional staff indicated that any such program must be aimed at obtaining rank and file coverage; thus, quicker vesting and no Social Security integration would probably be the price for obtaining staff support for an incentive package. Mr. Roche indicated that the Task Force was of the opinion that "no integration" was too large a price to pay for the package of changes outlined above.

In the discussion of the proposals, one Committee member noted that the funding recommendation (item (2) above) might involve too great a revenue impact—if so, it could be limited to smaller plans by, for example, making it applicable only to contributions below a specified dollar amount.

Mr. Roche then reported that the Task Force had discussed a position the IRS had taken in a private letter ruling. According to the IRS, ERISA requires that dividends from life insurance policies must be treated as actuarial gains—where the policies are being used to fund benefits in split_funded pension plans—and amortized in accordance with the plan's actuarial cost method. Mr. Roche indicated that the John Hancock Company has a request for a class ruling to change the funding method of plans before the IRS and the same issue had arisen. Mr. Roche stated that the Task Force decided that staff should work with the John Hancock in helping to resolve this problem with the IRS.

The Committee unanimously adopted the Task Force's report and recommendations.

PBGC Legislation

Harrison Givens, Chairman of the Task Force on Plan Termination, reported that Congress is presently considering what action to take regarding coverage of multi-employer plans under the pension plan termination program. At present, coverage is provided only on a selective basis. He noted that there are huge potential liabilities which is making a solution very difficult. In this regard, he recommended that the COuncil should support the principles of the legislative proposal developed by the PBGC (S.1076).

Moreover, Mr. Givens emphasized that the Council should take the position that the multi-employer plan termination insurance program should remain separate from the single employer plan termination insurance program since the two programs are different conceptually. He also recommended that the Council oppose any extension of coverage (and, thus, premiums) to other types of plans, e.g., profit-sharing.

In addition to his position on change in ERISA with regard to the plan termination insurance program's treatment of multi-employer plans, Mr. Givens recommended that the Council urge Congress to revise the "employer liability provisions" by: (1) eliminating the single sum settlement concept and replacing it with a requirement that the employer continue to fund his plan on an annual basis; (2) requiring that the post termination funding be geared to vested benefits, instead of guaranteed benefits; (3) eliminating the 30 percent of net worth limitation on the employer's liability; and (4) eliminating the contingent employer liability insurance provisions.

The Committee decided against taking a position on the way to deal with multi-employer plans. However, it approved Mr. Givens' recommendation for changes in the application of the plan termination insurance provisions to single employer plans and emphasized that the present Congressional consideration of the multi-employer plan issues provides a forum for the consideration of the single employer issues. The Committee noted that these recommendations were consistent with existing Council policy as reflected in the "Trial Design" of a plan termination insurance program developed by the Council in the early 1970's.

Report from the Task Force on Long Range Role of Private Pensions

Dave Hurd, Chairman of the Committee, reported that he and the Task Force have been looking into the best way for the Council to obtain basic research in the pension field. As a preface to his recommendation on how to obtain that basic research, Mr. Hurd analogized the public concern with private pensions today to the public's general unease following the Studebaker closing in the early 1960's where the concern was on the loss of pensions. According to Mr. Hurd, that unease in the 60's turned out to be a "gestation" period of discussion of pension problems which led to the enactment of ERISA 10 years later. Mr. Hurd stated that several years ago, the Pension Committee detected a similar unease associated with the extent of private pension coverage which led to the creation of the Long-Range Task Force. Mr. Hurd indicated that the Task Force has recognized (1) the desirability of a single voice to speak for the private pension business, and (2) the Council's need to develop industry positions in relation to public concern about extending pension plan coverage, assuring adequate pension benefits and containing the destructive impact of inflation. (The problems concerning pension plan coverage, adequate pension benefits and the impact of inflation on pensions were being examined largely through government sponsored research).

Mr. Hurd indicated that in furtherance of the belief that the insurance business must sponsor research to ensure that it can participate in future pension policy discussions and fend off further attacks on the private pension system, the Long-Range Task Force considered several alternatives to developing this research. Consideration was given to having the Council perform the research. This was seen as impractical given the size of the Council's staff and the time Committee members would actually have to give to provide assistance. Consideration was also given to entering into a contract with a research oriented organization, such as the Urban Institute (which already does much work under contract with Federal agencies in this area.) It was concluded that this approach would involve a heavy burden on the Council in designing research oriented to the insurance business and in assuring itself that the research would adequately reflect the detailed workings of the private pension sector.

Mr. Hurd explained that, after discussion, he and Mr. McLaughlin, Chairman of the Task Force, concluded that the best approach was to join the Employee Benefit Research Institute (EBRI), organized primarily by pension consultants. According to Mr. Hurd, this organization could serve indirectly as a voice for the pension industry, since it is involved in conducting researching the way the private sector wants to see it done, and this cooperative effort—between the insurance business, the consultants and other private sector interests—would assure more credibility for the private pension industry as a whole.

A staff memorandum was distributed to the Committee to provide more detail about the EBRI program. The salient features of the EBRI proposal, as reported in the memorandum, were that the Council would undertake a commitment of $300,000 to $400,000 per year as a contribution to EBRI. In return, the Council would nominate three persons to serve on the EBRI's Board of Trustees (presently EBRI has 13 trustees and plans to enlarge the Board to 25-30 trustees). It was pointed out that the fee and trustee membership are negotiable items. EBRI's current research plan is designed to cover about two years and would include: (1) a survey of existing literature; (2) the preparation of a research agenda based on judgement about existing gaps in knowledge on pensions and about what policy issues are apt to be critical; (3) the preparation of issue papers on retirement income programs, such as what retirement income levels should be established? What is the appropriate mix of public and private programs? and how should these programs be paid for?; (4) preparation of a series of study papers on recent status and trends in retirement income programs, including (i) coverage, participation and vesting; (ii) demographics; (iii) funding of retirement programs and the role of retirement markets and (iv) benefit levels and their adequacy; (5) the development of an integrated analysis of the impact of major policy alternatives over the long-term, including the interreaction of demographic characteristics, economic performance and capital markets and the mix of retirement income policies—this stage of the analysis will employ the dynamic micro simulation technique through contracts with the research agencies ICF and Mathematica; and (6) finally, the provision of an alternative policy forecast and an analysis of longer term policy issues, to be completed by June 1981.

It was reported that if the Council chose not to participate in EBRI, EBRI would begin to solicit insurance companies individually. EBRI is asking individual companies (insurance, banks, consulting firms and other private businesses) for $25,000 of one trustee slot.

Mr. Hurd invited comments about the EBRI proposal. In the general discussion, a number of viewpoints were expressed:

— Considerable doubt was expressed about the ability of EBRI to raise much money from direct solicitation of insurance companies.

— Some doubt was expressed about the technical competence of EBRI.

— A number of speakers expressed a preference for a research program explicitly focussed on a few specific questions that are important to life insurance companies. (In this connection, it was pointed out that the fundamental issue here—what retirement incomes will be 20-30 years in the future—makes the "specific" issues so interrelated that they have to be addressed from the standpoint of a basic model of the retirement income process).

— Several speakers emphasized the existence of a separate "Pension industry" and the desirability of participating in developing an effective voice for that industry.

— Several speakers felt that some sort of research effort was appropriate but that they had not been shown enough to make the case that this was the way to go.

— Several speakers expressed concern about the prospective "minority" status of the life insurance group in the EBRI Trustees.

Mr. Hurd suggested that the Committee had to decide (1) whether or not there should be some recommendation for Council action on establishing pension research, and (2) whether or not EBRI was the way to go. Mr. Hurd also expressed concern that if the

Committee were to select the EBRI route, would the Council fund the program if a proposal were not submitted to the Council's Board in a timely fashion. Richard Minck, Executive Vice President of the Council, responded to the latter concern. Mr. Minck pointed out that the Council has a long-standing program of sponsoring economic research, which is currently being carried on. The Board, historically, has funded very specific research projects with close supervision provided by Council committees and staff. With regard to non-specific research programs, the Board has generally taken the position that the companies, individually, may be the preferable way to fund such a program. Mr. Minck also pointed out that it is not imperative to rush a decision in order to have a project included in next year's program, since the Board has established contingency funds for unexpected expenditures and has, on special occasions, increased member company assessments to handle unexpected expenditures.

The Committee then voted on whether the Council should participate in basic pension research. The answer was unanimously yes. The Committee then voted on whether the Council should pursue at this time joining EBRI based upon the proposal presented to the Committee. The vote was no by a vote of 10 to 4.

The matter was left that the Long Range Task Force would continue discussions to develop additional research options.

Sex Discrimination

It was reported that the Council had just published a pamphlet entitled, "Private Pensions and Working Women". The pamphlet was passed out to the Committee members. The pamphlet was developed by a special Task Force headed by Dave Hurd to provide the press with an explanation of how defined contribution plans work and why lifetime monthly benefits will, and should, differ in amount for similarly situated men and women.

It was also reported that the Council has been carefully monitoring (1) EEOC's progress in developing an interpretative bulletin under the Equal Pay Act (the Council has met twice with the EEOC staff on a proposed bulletin requiring "equal benefits"; no final bulletin has been developed to date and probably will not be for a while); (2) the California Fair Employment Practice Commission's

proposed regulations on discrimination in employment (the Council filed comments and testified against an "equal benefits" requirement); and (3) recent court cases involving TIAA-CREF. Don Willard of TIAA-CREF gave a brief report on the disposition of cases TIAA-CREF is involved in.

Pension Survey Questionnaire for the President's Commission on Pension Policy

Harrison Givens asked that a Task Force be established to review a pension survey questionnaire which is being used to gather data on pension coverage for the President's Commission. He noted that the questionnaire was being used in a household survey and contained many difficult questions which it is hard to imagine people could answer. Thus, we should be prepared to rebut misleading conclusions. It was reported that Matt Greenwald, on the Council staff, was reviewing the questionnaire and had an appointment to discuss the study with Commission staff. The Chairman suggested that Harrison Givens be appointed to head such a Task Force and that other individuals who may be willing to serve on the Task Force notify Mr. Givens. The Committee unanimously approved the Chairman's suggestion.

IRS Joint and Survivor Annuity Provision Requirements—Profit-Sharing Plans

It was reported that George Powell of Prudential had informed staff that the Internal Revenue Service had indicated that it may take the position that a possibility of distribution in-kind of a life insurance contract necessitates qualified joint and survivor annuity provisions in a defined contribution plan. Under such a position, the IRS would hold that because the contracts distributed permit the participant to apply the cash value to an annuity, the plans would either have to be amended to make the joint and survivor annuity benefit the normal form of benefit or the contract would have to be amended to remove a life annuity as a settlement option. It was reported that a lawyer who was negotiating this point with the IRS had favorably resolved the issue in his case. Since there were no other expressions of concern, the Committee took no action.

Report on Council Testimony Before Various Government Commissions

Dave Hurd reported that he, along with other Council representatives, had testified before three Commissions:

(1) The National Commission on Social Security;

(2) The President's Commission on Pension Policy; and

(3) A Study Group of the President's Commission on Pension Policy.

His testimony before the three Commissions generally dealt with either the relationship between pension plans and Social Security or why the integration of pension plans with Social Security is an important component of pension planning.

Report on Effort to Move Legislation Allowing Deductions for Employee Contributions to Pension Plans

It was reported that several bills had been introduced during this session of Congress which would provide a limited exclusion from income tax for interest paid by banks and savings and loan associations. The Committee was informed that current Council policy regarding this type for legislation is not to seek to have the bills expanded to cover interest paid on life insurance accumulations, i.e., interest on proceeds left on deposit or interest on accumulated dividends. The Council's position does contemplate, however, clarifying the legislation at the Congressional staff level, so that if an individual borrows from a life insurance contract and deposits the money in a bank account to qualify for the exclusion, the deduction for the interest on the policy loan would be disallowed.

The Committee was further informed that the Council has established a special lobbying group to develop a lobbying strategy, both for the short-term and long-term, in order to create a constituency in Congress to support legislation which would allow deductible employee contributions to qualified pension plans or IRA's. It was further reported that there is probably no chance for such legislation this year, but for next year, the chances look better. In any event, such a proposal would be raised as a companion to legislation allowing tax

exemption for savings account interest—on the ground that it is also a way to create new capital formation.

The Next Pension Committee Meeting

The Committee agree that the next meeting would be held on January 22, 1980.

The meeting was adjourned at 2:40 p.m.

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006
(202) 862-4191

Stephen W. Kraus
Associate General Counsel

December 16, 1983

TO: Task Force on Fiduciary Matters

RE: Next Meeting

Your chairman has scheduled your next meeting for Thursday, January 26, 1984, in the Board Room of the Council's offices, beginning at 10:00 a.m. Since lunch will be served, please let Judy Grossman (202-862-4193) know if you will be attending.

The agenda for the meeting is as follows:

1. General Account Problem. As you are all well aware, ever since the enactment of ERISA, there has been concern regarding the treatment of general account assets and the potential application of ERISA's fiduciary responsibility provisions and prohibited transaction rules to these assets. In particular, the issue is whether general account assets are plan assets.

The Labor Department very early took a favorable position with regard to this issue in IB 75-2. Recently, however, the 7th Circuit Court of Appeals in Peoria Union Stock Yards Company Retirement Plan vs. Penn Mutual held that the assets held under a general account contract were "plan assets" and that Penn Mutual was a fiduciary with respect to these assets.

As a result of this recent activity, some companies believe that unless some action is taken quickly, either legislative or regulatory or a combination of both, the issue will be decided adversely to the industry. Most companies would consider this to be an unacceptable result.

Accordingly, you should be prepared to discuss this issue and what action the Council should take in attempting to achieve a

favorable resolution. Also, other general account issues will be discussed including the questions raised by the decision in Chicago Board Options Exchange vs. Connecticut General. I am enclosing some material prepared by Groom & Nordberg and the Aetna for your information.

2. Shared Real Estate Investments. A report will be given regarding this issue, particularly the status of the Advisory Opinion request submitted by the Metropolitan and the class exemption submitted by the Equitable. There is enclosed for your information a copy of an exemption application recently submitted by the Metropolitan dealing with this issue.

3. Guaranteed Interest Contracts Separate Accounts. As you will recall, a request was filed with the Department of Labor for an Advisory Opinion which would state the position of the Department of Labor that guaranteed interest contract separate account assets are not "plan assets". Recently, the Labor Department issued a favorable Advisory Opinion, a copy of which is enclosed for your information. A report will be given regarding the status of the class exemption that was proposed in connection with this issue and the need for finalizing the exemption in light of the favorable Advisory Opinion letter.

If there are any other issues you would like placed on the agenda please let me know as quickly as possible. Also, if any company wishes to invite their Washington Representative to the meeting to participate, particularly in the discussion concerning the general account asset question, you are certainly welcome to do so.

I wish you all a happy holiday season and a healthy and happy New Year. I look forward to seeing you all on January 26.

Sincerely,

Stephen W. Kraus

SWK/jsg
Enclosure

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006
(202) 862-4191

Stephen W. Kraus
Associate General Counsel

March 22, 1984

TO: Pension Committee
Pension Committee Task Force on Fiduciary Matters

RE: General Asset Account Proposed Legislation

Enclosed is a copy of a memorandum we just filed with the Labor Department setting forth the basis for the details of our proposal to amend ERISA in order to clarify that the fiduciary responsibility and prohibited transaction provisions do not apply to the investment or management of general account assets or to the exercise of rights accorded to life insurance companies under general account contracts issued to employee benefit plans. We are attempting to meet with Mr. Monks, the new Administrator of the Labor Department's Office of Pension and Welfare Benefit Programs, as soon as possible.

A meeting will take place on Friday, March 23, between Secretary of Labor Donovan and Mr. Schweiker, who will be accompanied by two Chief Executive Officers. The purpose of this meeting is to impress upon Secretary Donovan the importance of the general account contract issue and the need for prompt Labor Department consideration.

I appreciate the many comments received in connection with the development of the enclosed memorandum. I hope that all of the significant items have been incorporated into the memorandum.

If you have any questions or would like to further discuss this matter with me, please do not hesitate to call.

Sincerely,

Stephen W. Kraus

SWK/jsg
Enclosure

PROPOSED ERISA AMENDMENT

INSURANCE COMPANY GENERAL ACCOUNT CONTRACTS

This memorandum sets forth the basis for and the details of a proposal to amend the Employee Retirement Income Security Act of 1974 (ERISA) to clarify that the fiduciary responsibility and prohibited transaction provisions of ERISA do not apply to the investment or management of the general corporate assets of life insurance companies (the insurer's "general account") or to the exercise by life insurance companies of rights accorded to them under general account contracts issued to employee benefit plans.

I. Introduction

Insurance company contracts are one of the primary vehicles for the funding and distribution of retirement benefits to participants and beneficiaries of employee benefit plans in the United States.* As in the case of insurance policies issued to individuals and entities for other purposes, considerations paid to the insurer under most of these contracts become a part of the insurer's general corporate assets (usually referred to as the insurer's "general account").* It is out of the

* At the end of 1982, retirement plans funded with life insurance companies covered 30.5 million persons and provided retirement income to 3.1 million individuals. The pension reserves supporting these plans equalled $228.9 billion at the end of 1982, of which $174.9 billion was held in insurance company general accounts. Total insurance company general account assets exceeded $422 billion by the end of 1982. American Council of Life Insurance, Pension Facts (1983).

* Some insurance company contracts issued to pension plans provide for the allocation of contract deposits to one or more segregated asset accounts (separate accounts) and entitle the contractholder/plan to a pro rata share of the investment experience of the assets held in the separate accounts. Some insurance companies also maintain separate accounts that are utilized solely in connection with contracts providing for guarantees of principal and interest rate or for non-participating fixed annuities. Contractholders of these contracts do not share or participate in the investment experience of such separate accounts, and the Labor Department has taken the position that the assets of these separate accounts do not constitute "plan assets" for purposes of ERISA. See DOL Advisory Opinion 83-051A (September 21, 1983). The ERISA amendment proposed herein would codify the Department's position with respect to this type of separate account.

general account that an insurer pays all of its obligations to its policyholders (other than contractholders participating in its separate accounts) and its creditors, supports all of its other business activities, and, in the case of stock insurance companies, pays dividends to its shareholders. While many of these general account contracts involve participation by the contractholder/plan in the investment or mortality experience of the insurer, all of these contracts involve the assumption by the insurer of certain obligations (which vary from contract to contract) that go beyond the obligation merely to pass through to the contractholder a pro rata portion of the investment gains and losses of an identified pool of assets. Consequently, besides specifying the obligations of the insurer to the plan and its participants and beneficiaries, insurance company contracts offered to retirement plans typically will accord to the insurer various rights that it may exercise at its discretion for the protection of its own interests and those of its other policyholders in connection with the control and management of the risks which it has assumed under the contracts. Many of the rights accorded to the insurer are designed to comply with state insurance laws that require that policyholders not suffer unfair discrimination.

Since ERISA's enactment, the life insurance industry has conducted its business on the basis of a common understanding that its general account assets (as distinguished from its separate account assets) are not "plan assets" under ERISA and that, consequently, it is not subject to ERISA's fiduciary responsibility and prohibited transaction provisions in managing such assets or in exercising discretionary contractual rights accorded to it for the purpose of managing the risks which such assets must support. This understanding has been based on the legislative history of ERISA and interpretation of ERISA by the Department of Labor and the IRS. Recently, however, based largely on ambiguities in the statutory language, the Seventh Circuit Court of Appeals has rendered two decisions* which call this understanding into question and which undermine the intent of Congress to exclude insurance companies from fiduciary status

* Peoria Union Stockyards Company Retirement Plan v. The Penn Mutual Life Insurance Company, 698 F.2d 320 (7th Cir. 1983) and Chicago Board of Options Exchange v. Connecticut General Life Insurance Company, 713 F.2d 254 (7th Cir. 1983).

with respect to their general account business. While the holdings in those cases are, of course, limited to their particular facts, they create precedential authority for the broad application of ERISA's fiduciary responsibility and prohibited transaction provisions to (i) the management by an insurer of its general account assets, and (ii) the exercise by an insurer of discretionary rights accorded to it under general account contracts with employee benefit plans. Such a broad application of ERISA would materially and adversely affect the insurance industry's management and investment of billions of dollars of assets and the anticipated operation of hundreds of thousands of contracts to the detriment of the industry, its policyholders (including employee benefit plans), shareholders and third parties that look to insurance company general accounts as a source of investment funds for their businesses. Moreover, such an application of ERISA would conflict with the broader regulatory scheme imposed on an insurer's general account operations under state insurance laws.

The general account of an insurance company is not a mere commingled investment fund for employee benefit plans, but reflects all of the assets and liabilities of all the insurance and ancillary operations of an insurance company, except those assets and liabilities specifically allocated to separate accounts. Usually, the greatest number of general account contractholders of a life insurance company are owners of life insurance policies, beneficiaries of such policies and others who are not participants in employee benefit plans. Thus, the normal operations of a life insurance company require that decisions be made with respect to the management of assets and exercise of contractual rights that may affect different classes of contractholders or branches of the company's business in different ways. State insurance regulation of an insurer's operation of its general account and issuance and management of general account contracts is designed to reconcile and protect the interests of all parties having an interest in the general account.

In contrast, the application of ERISA's fiduciary responsibility provisions would require insurers to manage general account assets and exercise discretionary rights under general account contracts "solely in the interest of [employee benefit plan] participants and beneficiaries," and "for the exclusive purpose of providing benefits"

to such participants and beneficiaries. Literally applied, the application of these provisions might preclude an insurance company from utilizing its general account assets to pay benefits to non-ERISA-covered policyholders or to pay dividends to its shareholders. Or, these provisions might preclude an insurer from exercising a contractually granted discretionary right to amend a contract in the event that the risks under such contract had materially changed in such a way as to impair the insurer's ability to satisfy its obligations to its other policyholders. Insurance companies cannot be expected to disregard the interests of non-employee benefit plan policyholders or to favor the interests of plan contractholders over other classes of policyholders, or to disregard the interests of all other employee benefit plan contractholders when taking action under one contract issued to a plan. Nevertheless, such a result, which was clearly never intended by Congress, might obtain if ERISA's fiduciary responsibility provisions were broadly applied to an insurer's general account business.

Additional problems would result from the application of the prohibited transaction restrictions of ERISA to the investment of insurance company general account assets. Under the prohibited transaction restrictions, an insurer might not, without prior government approval, be able to engage in any investment transaction with any company or person that is a "party in interest" with respect to any plan that is a general account customer of the insurance company. Because the definition of "party in interest" is extremely broad, and because insurance companies may have general account contracts with thousands of employee benefit plans, these restrictions, if applied, would disrupt the vast majority of an insurer's customary investment transactions. However, as the Labor Department and the IRS have acknowledged in interpreting ERISA to exclude general account assets from treatment as plan assets, because of the size of an insurer's general asset account and the large number of general account policyholders, the risk of any one plan being able to influence the investment policy of an insurer respecting the general account is extremely slight and, therefore, the protections for plan participants and beneficiaries provided by the prohibited transaction provisions would be of no practical value in this context.

Because of the uncertainty that has been created by the recent court decisions and the widespread negative impact that these deci-

sions might have, legislation is needed as soon as possible to make clear that the fiduciary responsibility and prohibited transaction provisions of ERISA do not apply to the investment and management of insurance company general account assets or to the exercise of discretionary rights by insurance companies accorded to them under general account contracts issued to employee benefit plans. The current lack of certainty in this area stems mainly from the ambiguous language of ERISA itself. Thus, only Congress can definitively correct the problem.

The discussion below describes the background of this issue, the development of the law in this area, and the policy considerations that militate against applying ERISA's fiduciary responsibility and prohibited transaction provisions to insurance company general account operations. This discussion is followed by a proposed amendment to ERISA that would clarify the law in this area.

II. Development of General Account Contracts

At the time ERISA was enacted, by far the greatest part of the huge amount of assets held to pay retirement benefits to privately employed persons was held by banks and insurance companies, but in significantly different ways. Banks held retirement plan assets in trust, with the assets of each plan ordinarily held in a separate trust.* Employer contributions could be traced into the stocks, bonds and real estate bought for each plan. The bank trustee did not guarantee interest, investment performance or the preservation of principal. The assets of each plan could be easily identified; they were managed by the bank trustee or by another adviser retained to so; and they simply grew (or diminished if, for example, the stocks in which they were invested decreased in value) with whatever investment results were achieved.

Insurance companies provided a very different facility. Over the past 30 to 40 years, they have sold annuity contracts, primarily group

* At the end of 1973, about $126 billion were held by banks and $56 billion by insurance companies. Details taken from Pension Facts 1976 (American Council of Life Insurance). Beginning in the mid-1950's, banks began to commingle the assets of several plans in what were known as commingled pension trust. This was done to provide more efficient investment of, primarily, the assets of . . . [TEXT CUT OFF]

annuity contracts, that set forth contractual promises, commonly referred to as "guarantees," describing the rights of the contractholder (e.g., the employer or other plan sponsor) and the "benefits" to be paid to the employees covered by the plan and their beneficiaries. Except for "separate account contracts," these contracts invariably provided for a bookkeeping "account" to which would be credited the employer's contributions and interest and other amounts, such as dividends or rate credits, that to some extent were expressly guaranteed and to some extent left to the discretion of the insurer based on its investment and mortality experience.* This bookkeeping account would also be debited with amounts used for the payment of pension and with any fees or charges stated in the contracts. The contracts generally promised that the amounts accumulated in the account could be used to provide annuities at guaranteed rates for retiring employees.

Additionally, these contracts typically provided various options under which amounts could be withdrawn under the contract upon its termination or for diversion by the plan to another funding or distribution vehicle. Depending upon the circumstances of the withdrawal and the specific withdrawal option selected, amounts withdrawn might be payable at book value or might be subject to adjustment to reflect gains or losses resulting from the diversion of investment income or sale of investments by the insurer to accommodate such withdrawals. These adjustment provisions reflected the fact that insurers, in accepting and managing risks under general account

* Separate accounts were authorized un[illegible] ate insurance laws in order to allow insurers to offer products to pension p[illegible] which provided plans with the actual investment performance achieved in "their" assets and, thus, be able to compete with bank trust funds. These laws enable the insurer, through the use of a "separate account annuity contract," to segregate the assets of the individuals plan from its general account, invest them separately, and credit the plan with actual investment results. Alternatively, the insurer could hold assets in a commingled separate account, similar to a commingled trust, under which each plan participating in the separate account would be credited with its pro rata share of actual investment results. The Congress, recognizing that insurance companies had no beneficial interest in separate account assets and did not share in the investment performance of these assets, amended the Internal Revenue Code to exempt investment income and capital gains and losses arising from such accounts from the federal income tax laws applicable to insurance companies. Like a bank trustee, the insurer simply received a fee for managing the assets in the separate accounts.

contracts, contemplated a long-term relationship with the plan. Where the contractholder determined voluntarily to make withdrawals for reasons other than to pay benefits when due, fairness to the insurer and its other employee benefit plan and non-employee benefit plan general account policyholders required that adjustments be made to reflect the economic consequences of the particular contractholder's voluntary withdrawal.

Because contracts issued to pension plans commonly extend over long periods of time during which changes in environmental conditions affecting the insurer's investment or mortality experience as well as changes in the plans could materially affect the insurer's risk, the contracts also typically accorded the insurer various discretionary rights which it could exercise for its own protection and the protection of its other policyholders to avoid or ameliorate unreasonably high or unforeseen adverse financial experience or risk exposure. Such rights might include rights to prospectively modify guarantees, defer withdrawal payments or amend provisions of the contract. The existence of these rights can also be an important factor in reducing risk charges imposed under these contracts.

Premiums received under these contracts became part of the general account of the insurer and were invested to the extent not used for other corporate purposes. No contribution, or premium, could be traced into the assets in which it was invested. In the case of a large company, amounts received became an indistinguishable part of its billions of dollars of assets.

Many contracts that have been issued by insurers to retirement plans are "participating" contracts that were developed in recognition of the possibility that favorable financial experience could occur over the long periods that these contracts are normally intended to be in effect (e.g. 30 to 40 years or more). Under these contracts, the insurance company typically guarantees the principal amount (i.e., the consideration paid under the contract), any earnings that have previously been accumulated under the contract, and the continued payment at fixed levels of any annuity benefits. Favorable general account investment, mortality or expense experience beyond these guarantees is either distributed to the contractholder via dividends or

is credited to the contractholder's account, depending on the contract form.*

Thus, contracts funded through an insurer's general account were and continue to be fundamentally different from arrangements such as trusts, advisory agreements, and insurance company separate accounts to which ERISA's fiduciary provisions generally apply. Unlike such other arrangements, general account contracts have several essential characteristics which make the application of ERISA's fiduciary responsibility provisions inappropriate and impractical.

First, general account contracts involve the assumption of obligations by the insurance company that go beyond the obligation merely to pass through to the contractholder a pro rata portion of the investment gains and losses of a specified pool of assets. Such obligations vary from contract to contract, but may include guarantees of principal, minimum rates of interest to be credited to the contractholder's account, guarantees of premium rates at which annuities can be purchased, and obligations to repay specified amounts upon contract termination. Because many of these contracts provide for varying degrees of participation by the contractholder in the investment, mortality, or expense experience of the insurer, few of the contracts can factually be said to be totally "guaranteed." However, all of these contracts involve some measure of risk assumption by the insurance company that is not present in a typical trust or asset management arrangement.

Second, all of the obligations of an insurance company are secured by the assets held in the company's general account on an unsegregated basis. These obligations include not only the company's obligations to its ERISA-covered plan contractholders, but its life,

* Participation in the investment experience of the insurer generally takes the form of an allocation of the insurer's investment income among classes of contractholder funds. This allocation may be in proportion to total funds, or may be in accordance with any investment year method. Investment year methods may be applied over the entire general account, or separately to major business segments of the general account. Such allocation methods, however, do not in any way constitute an identification of specific general account assets with specific obligations of the insurer. All assets of the general account stand behind all general account obligations.

accident and health insurance policyholders as well as its general creditors. Therefore, any actions which an insurer takes with respect to its general account assets or with respect to any particular general account contract potentially affect all of the insurer's general account policyholders, shareholders and creditors.

Third, the nature and extent of the contractual obligations and guarantees assumed by insurance companies vary widely from one type of contract to another (e.g., between disability contracts, health insurance contracts, and employee pension benefit plan contracts) as well as among contracts of the same type. Therefore, any particular action which an insurer takes in connection with its general account assets or particular contracts will not necessarily affect all parties with an interest in the general account in the same fashion.

These factors together — the assumption of risks by the insurance company, the security provided for all general account obligations by all of the assets of the insurance company's general account on an unsegregated basis, and the variety of obligations and guarantees assumed by the insurance company — require an insurance company to manage its general account on a basis that permits it to satisfy its obligations and guarantees to, and consider the welfare of, all of its contractholders (and, in the case of stock companies, its shareholders), not solely its employee benefit plan contractholders.

By contrast, the fiduciary (trustee) of a trust fund or account or the fiduciary (insurance company) of a separate account is only obligated to return the assets held in the account, plus or minus any gains or losses, and to act in a manner consistent solely with the needs of the account's beneficiaries. Also, assets of a trust or separate account must be law be segregated solely for the beneficiaries of that account, or pooled solely with assets of like accounts. For these reasons, if trust or separate account assets lose value or become entirely worthless, the fiduciary, in the absence of a breach of its fiduciary responsibilities, has no obligation to make up the loss or to pay benefits regardless of the loss, nor are other assets of the fiduciary available to make up the loss. Additionally, assets held in trust may not be used by a fiduciary to satisfy non-trust obligations that the fiduciary has assumed. Further, because the trust or separate account arrangement legally isolates the account's assets from other assets

held by the fiduciary, requiring the fiduciary to satisfy the "exclusive benefit" requirements of ERISA does not affect other parties to whom the fiduciary has obligations, nor does it require the fiduciary to conduct its independent business affairs contrary to its own interests.

These differences between the general account of an insurance company and a separate account or trust fund were recognized when the fiduciary responsibility provisions of ERISA were enacted.

III. Development of the Law

As indicated above, contracts funded through an insurer's general account have several characteristics which distinguish them from trusts, advisory agreements, and insurance company separate accounts and which make the application of ERISA's fiduciary responsibility provisions to those contracts inappropriate and impractical. Thus, Congress, in enacting ERISA, expressed a clear intent to exclude an insurer's management of its general account business from ERISA's fiduciary responsibility and prohibited transaction provisions. Such intent has been consistently supported and reinforced by the Department of Labor and IRS in agency interpretations. Unfortunately, the statutory provision designed to effectuate Congress's intent is not clearly drafted and leaves room for various interpretations, as evidenced by the Peoria and CBOE decisions.

Under ERISA, a determination of whether a person is a fiduciary with respect to a plan generally depends on whether such person has any discretionary authority, responsibility or control with respect to the management of "plan assets." ERISA section 3(21)(A). Although the term "plan assets" is not defined in ERISA, section 401(b)(2) provides an exclusion from "plan assets" treatment for insurance company assets maintained in connection with "guaranteed benefit policies." Specifically, section 401(b)(2) of ERISA provides that —

> In the case of a plan to which a guaranteed benefit policy is issued by an insurer, the assets of such plan shall be deemed to include such policy, but shall not, solely by reason of the issuance of such policy, be deemed to include any assets of the insurer.

* * * *

(B) The term "guaranteed benefit policy" means an insurance policy or contract to the extent that such policy or contract provides for benefits the amount of which is guaranteed by the insurer. Such term includes any surplus in the separate account, but excludes any other portion of a separate account..*

The language of this provision has been the source of some uncertainty regarding general account contracts because of the use of the term "guaranteed benefit policy." The insurance industry has acted with the understanding, however, that all general account contracts are "guaranteed benefit policies" because such policies involve the insurer's assumption of obligations that, unlike a trust arrangement or separate account, go beyond the obligation merely to pass through to the contractholder a pro rata portion of the investment gains and losses of a specified pool of assets. Indeed, any contrary interpretation would have rendered the "guaranteed benefit policy" language meaningless because if even one general account contract were not regarded as a "guaranteed benefit policy," all of an insurer's general account assets would, in effect, become "plan assets" as in the case of pooled investment funds such as bank collectively trusts and pooled separate accounts.

Additionally, while the statutory language clearly provides that the "guaranteed benefit policy" itself is a plan assets, it was understood that such designation was intended merely to confirm that the exercise by a plan administrator, trustee or other party of the rights <u>accorded to the plan</u> under the contract would be subject to ERISA's fiduciary responsibility provisions, as distinguished from the insurer's management of the assets held under the contract or its exercise of the contractual rights <u>accorded to it</u> for its own protection and the protection of all of its policyholders in connection with the management of such assets and the risks which they support. There was no

* Even in the absence of the section 401(b)(2) exclusion, the general account assets of an insurer should not be regarded as "plan assets," for reasons similar to those that support the conclusion that the assets of other business corporations with which a plan may contract are not plan assets. It is therefore particularly unfortunate that a statutory exclusion which should have simply made clear a particular application of a broader principle has been read by some courts as a narrow limitation.

basis to read this clarification that plan trustees hold "guaranteed benefit policies" as fiduciaries — just as they hold other non-insurance contract rights — as implying that the insurer, unlike any other party to a contract with an employee benefit plan, is a fiduciary in exercising its rights under the contract.

The conclusion that general account assets are not subject to ERISA's fiduciary responsibility provisions is amply supported by both the legislative and administrative history of ERISA. The last Senate bill preceding the enactment of ERISA provided that the fiduciary responsibility provisions would not apply to "funds of an insurance carrier unless that carrier holds funds in a separate account." See section 511 of the Senate amendment to H.R. 2. Further, in the staff summary of the Senate and House versions of ERISA that was used by the ERISA conference committee, it was stated that under the Senate amendment to H.R. 2, the fiduciary responsibility provisions would not apply to funds held by an insurance company unless they are held in separate accounts and that the policy of the House bill was the same. Summary of Differences Between the Senate Version and the House Version of H.R. 2 To Provide for Pension Reform, Part Three, Fiduciary and Enforcement, June 12, 1974, at 2 and n.3. Thus, although the language of section 401(b)(2) was somewhat ambiguous, the intent of Congress to exempt insurance companies from coverage under the fiduciary responsibility provisions of ERISA in connection with their general account contracts was clear.

This Congressional intent is further evidenced by the treatment of separate account surplus in section 401(b)(2) of ERISA. The suggestion for inclusion of a provision for the treatment of such surplus was included in the Summary of Differences used by the ERISA conferees. In brief, separate account surplus is funds transferred to a separate account from an insurance company's general account. Under section 401(b)(2), as quoted above, all assets of the separate account are treated as "plan assets" subject to the fiduciary responsibility provisions of ERISA, except "surplus in the separate account." If surplus is not "plan assets" in a separate account, it makes no sense to treat the same assets as "plan assets" when in the general account.

Shortly after ERISA's enactment, the life insurance industry requested that the Labor Department and the IRS issue interpretive rulings to resolve any ambiguity raised by section 401(b)(2). This interpretive request included descriptions of various types of contracts (e.g., deferred annuity contracts, deposit administration contracts, immediate participation guarantee contracts) under which contractholder payments are allocated to an insurer's general account and which involve elements of participation in the insurer's investment and mortality experience.

In response, and as one of their first major pronouncements under ERISA, the Labor Department and the IRS promulgated Interpretive Bulletin 75-2 (February 6, 1975) ("IB 75-2"). IB 75-2 generally provides that the investment by a plan in securities of a corporation or partnership will not, solely by reason of such investment, be considered to be an investment in the underlying assets of such corporation or partnership so as to make the assets of such entity "plan assets." In particular, IB 75-2 provides that —

> if an insurance company issues a contract or policy of insurance to a plan and places the consideration for such contract or policy in its general asset account, the assets in such account shall not be considered to be plan assets.

Interpretive Bulletin 75-2 did not purport to amplify the meaning of "guaranteed benefit policy," but rather stated simply and directly that the assets maintained in connection with an insurer's general account are not plan assets. The fact that general account assets were addressed in an interpretive bulletin dealing with the assets of corporations and partnerships is important, for it reflects a recognition that the general corporate assets of a insurer, like the assets of any other business, could not be managed exclusively for the benefit of employee benefit plans which might be deemed to have an interest in such business.

Shortly after IB 75-2 was issued, Paul J. Fasser, Jr., Assistant Secretary of Labor for Labor Management Relations, explained to a Subcommittee of the House Committee on Labor and Education some of the reasons why general account assets are not treated as plan assets for purposes of the fiduciary responsibility provisions of

ERISA. His statement to the Congress is worth quoting at some length:

> Let's take a large multiemployer plan, having several thousand contributing employers, the benefits of which are wholly insured but not fully guaranteed. The insurance company invests the premiums it receives from the plan along with premiums received from other policyholders, in a wide variety of ways: corporate and government bonds, real estate mortgages, other secured loans, and some equities, to mention a few. Section 401(b) could be read to mean that the insurance company could not invest its premium receipts in bonds or equity securities issued by any of the employers contributing to the policyholder plan, it could not allow any of these employers to lease space in a building on which it held a mortgage, and it could not purchase goods, services, or facilities from any one of those employers.
>
> With the introduction of expensive recordkeeping equipment to keep track of all the contributing employers so as to avoid doing business with them, these restrictions might have been manageable if the insurance company insured the benefits of only one or a few plans, but some of the large carriers have sold policies to thousands of plans. We studied the law and the underlying rationale of the prohibited transactions provisions, we studied the legislative history, we conferred with our colleagues at the Internal Revenue Service, we applied our collective common sense, and we concluded that Congress did not intend this result. We recognized that the prohibited transactions restrictions are designed to avoid conflicts of interest situations, but we knew that where the premiums paid by a plan are placed in an insurance company's general asset account, along with the assets of many other plans, the risk of any one plan being able to influence the investment policy of the insurance company respecting the general asset account is extremely slight.
>
> So we exercised our authority to interpret the law and we published an interpretive bulletin — the Service published an identical technical information release — stating that

> the mere investment of plan assets by a plan in a corporate entity or partnership does not convert the assets of the corporation or partnership into plan assets and does not make the managers of the corporation or partnership fiduciaries to the plan. Those managers are thus not restricted from engaging in normal business transactions, including transactions with persons who happen to be parties in interest with respect to the policyholder plans.

Oversight on ERISA: Hearings on Public Law 93-406 before the Subcommittee on Labor Standards of the House Committee on Education and Labor, 94th Cong., 1st Sess. 390-91 (1975).

The Labor Department has reiterated the interpretation set forth in IB 75-2 on a number of occasions. For example, in the preamble to its proposed "plan assets" regulation, the Department stated that IB 75-2 interpreted ERISA section 401(b)(2) "to mean generally that assets held in an insurer's general account to support benefits under a contract purchased by a plan are not plan assets. . . ." 44 Fed. Reg. 50363, 50364 n.4 (Aug. 28, 1979). See also Prohibited Transaction Exemption 79-41, 44 Fed. Reg. 46365, 46368 (Aug. 7, 1979); 46 Fed. Reg. 46443, 46444 (Sept. 18, 1981). Further, in the proposed "plan assets" regulation, the Department adopted essentially the same exception from plan assets treatment for general account assets as that in IB 75-2. Prop. DOL Reg. § 3550.401b-1(d), supra, at 50363.

In the 10 years since ERISA's enactment, neither the Department nor the IRS has taken any enforcement or other action inconsistent with their above-cited pronouncements.

IV. The Peoria and CBOE Cases

In 1983 the United State Court of Appeals for the Seventh Circuit rendered two decisions, the Peoria and CBOE decisions, which undermine the intent of Congress in enacting section 401(b)(2) of ERISA and the interpretations of ERISA that have been issued by the Labor Department and the IRS. It is important to note that neither the Labor Department nor the IRS was a party to, or made an appearance in, either of these cases.

A. Peoria Case

In Peoria Union Stockyards Company Retirement Plan v. The Penn Mutual Life Insurance Company, 698 F.2d 320 (7th Cir. 1983), the Court held that a deposit administration contract was not a "guaranteed benefit policy" for purposes of section 401(b)(2) because the plan contractholder participated in the investment performance of the general account during the accumulation phase of the contract (i.e., prior to the allocation of funds to provide fixed annuities for retirees). The Court suggested that the determination of whether a general account contract is a "guaranteed benefit policy", and, therefore, whether amounts allocated to the company's general account under the contract are "plan assets" subject to ERISA, may turn on whether the rate of return under the contract is fully guaranteed by the insurance company. The Court was of the view that the insurer, during the accumulation phase of the contract, served merely as an investment advisor and that the contract was not a "guaranteed benefit policy," but was more analogous to a trust arrangement.

This analogy was inappropriate. During the accumulation phase of a contract, the insurer typically bears risks that are not a part of trust or investment advisory arrangements, such as guarantees of principal and interest previously accumulated, minimum interest guarantees, and the right of contractholders to effect annuities at any time under a guaranteed price structure. See S. Huebner and K. Black, Life Insurance, at 605 (8th ed. 1972). In addition, the Court's bifurcated approach (i.e., the accumulation phase or active life fund and the liquidation phase or retired life reserve fund) to interpreting the contract is inconsistent with the fact that all of the assets of the general account are required by applicable state insurance laws to stand behind each phase of a contract. Thus, the same assets support both the active life fund and annuities for retired lives. This is not analogous to a trust arrangement where the trustee is only responsible for a segregated pool of assets.

Under the Court's holding, it would appear that any participation by a plan contractholder in the investment experience of the general account might be interpreted to preclude the applicability of the exception under section 401(b)(2). This obviously could not have been the result intended by Congress since most general account

contracts commonly offered to pension plans by insurers at the time ERISA was enacted provided for some degree of participation. The Court's interpretation would, therefore, render both section 401(b)(2) and its underlying legislative rationale virtually meaningless. Moreover, as indicated earlier, if only one general account contract is deemed not be a "guaranteed benefit policy" under the Court's test, all of the assets of the general account could be regarded as "plan assets" subject to the fiduciary responsibility provisions of ERISA.

B. CBOE Case

Shortly after the Peoria decision was issued, the Seventh Circuit again held that an insurer was a fiduciary with respect to a general account contract, but based its decision on a different rationale. In Chicago Board of Options Exchange v. Connecticut General Life Insurance Company, 713 F.2d 254 (7th Cir. 1983), the insurer exercised the contractual right expressly accorded to it to unilaterally amend a group annuity contract which was held by the Chicago Board of Options Exchange on behalf of its defined contribution money purchase thrift plan. The amendment had the effect of allowing the insurer to invoke its right to defer contractholder withdrawals under the contract where the withdrawals were for purposes other than the payment of benefits under the plan. The contractholder filed suit alleging, among other things, that the insurer, in so amending the contract, breached its duties as a fiduciary under ERISA with respect to the plan.

In reviewing the allegation of breach of fiduciary duty, the Seventh Circuit first concluded that Connecticut General was not a fiduciary by virtue of accepting deposits from CBOE and investing such deposits in its general account inasmuch as the contract appeared to be a "guaranteed benefit policy," and, therefore, deposits to the general account were not plan assets. However, the Court then noted that the group annuity contract itself was a plan asset, and concluded that Connecticut General was a fiduciary by virtue of its right to unilaterally amend the contract.

The reasoning of the Court in this case, however, overlooks the nature of the contractual arrangement and could lead to results that were certainly never intended by Congress. Like any contractual

arrangement entered into between two parties, when an employee benefit plan enters into a general account contract with an insurer, both the plan and the insurer grant to each other certain rights and agree to certain obligations. While it is clear that such a contract is a "plan asset" and that the exercise by a plan administrator or trustee of the rights accorded to the plan under the contract are subject to ERISA's fiduciary responsibility provisions, it does not logically follow that an insurer should be subject to the same fiduciary provisions when exercising the rights accorded to it for its own protection under the contract. Such reasoning would suggest that no issuer of a financial instrument to an employee benefit plan could ever retain discretionary rights which it could exercise for its own self-interest. For example, a corporation that has issued stock acquired by an employee benefit plan could, under such reasoning, be subject to ERISA's fiduciary responsibility provisions in exercising its discretion regarding whether to declare dividends; or a corporation that has issued a bond acquired by an employee benefit plan could be regarded as a fiduciary in determining whether or not to exercise a discretionary right to prepay its obligations under the bond. Thus, where any of these contractual arrangements are established, it must be recognized that both the plan and the other party agree to assume certain obligations and grant to each other certain rights which it is understood each party will be free to exercise under the terms of the contract, in its own self-interest. This fundamental principle is at the very heart of all contractual arrangements, including insurance company general account contracts typically issued to employee benefit plans.

Because of the nature of its business, the insurance industry would be particularly adversely affected by any interpretation of ERISA which precluded a company that had entered into a contract with an employee benefit plan from maintaining and exercising discretionary contractual rights for its own protection and the protection of its other policyholders. The primary business of an insurer is the assumption, pooling and management of risks. In order to prudently manage such risks, many of which may extend over very long or indefinite durations, an insurer in many instances must retain the flexibility and discretion under a contract to modify its terms or take such other discretionary action as is necessary to protect its

interests and the interests of its other policyholders when the risks which it originally assumed under the contract change materially in either their nature or magnitude because of changing or unforeseen circumstances.* It would be impossible for an insurer to manage the risks which it assumes under any general account contract without considering its obligations to its other policyholders inasmuch as the same assets must under state insurance law support and are exposed to all such risks. Such a result was never intended by Congress, as is evidenced by the provision to exempt "guaranteed benefit policies" from the fiduciary responsibility provisions of ERISA. It is, moreover, anomalous to conclude, as the Seventh Circuit has done in the CBOE case, that while an insurer by virtue of that exemption is not acting in a fiduciary capacity and may take into account the interests of its non-ERISA policyholders and shareholders in managing its general account assets, the same insurer is acting in a fiduciary capacity and cannot take into account such interests when it exercises discretionary rights accorded to its under a contract for the purposes of managing the liabilities which must be paid from the assets in its general account.

The following examples are illustrative of situations where an insurer may retain contractual discretion to manage its risks, where it is necessary for the insurer to represent its own interests and the interests of other policyholders in exercising such discretion and where the application of ERISA's fiduciary responsibility provisions would produce unreasonable and unintended results:

1. General account contracts issued in connection with retirement plans frequently are for long terms, or may have no definite maturity date and may, therefore, extend for an indefinite duration. However, such contracts typically accord to both the plan and the insurer the right to terminate the contract unilaterally under certain

* Any particular contract will set forth the specific discretionary rights which are accorded to the insurer and the conditions under which they may be exercised, and it is generally understood by the parties representing the plan in connection with the contract that such rights are intended to be exercised by the insurer on its behalf. The plan administrator or trustee representing the plan has a fiduciary obligation not to enter into such a contract unless it has determined that the discretion afforded the insurance company is reasonable in the context of the contractual obligation. . . . **[TEXT CUT OFF]**

circumstances. For example, an insurer may be accorded the right at its discretion to terminate a contract funding a defined contribution plan in the event that the plan is modified to expand the circumstances under which participants may withdraw amounts from the plan at book value. If the insurer were a fiduciary and it were required to act solely for the benefit of the participants of that plan, it might be foreclosed from exercising its right to discontinue the contract regardless of its increased exposure to losses by virtue of the plan modification and the effect of such exposure on its other policyholders, including employee benefit plan contractholders.

2. General account contracts often provide that an insurer may from time to time modify (i) guarantees as to the interest rate which will be credited to amounts deposited under the contract, (ii) guarantees as to the premium rates at which annuities can be purchased for plan participants, or (iii) formulas for determining the amounts payable to the contractholder under certain contract discontinuance options. Such discretion is necessary to protect the insurer from undue increases in its risk exposure resulting from environmental changes affecting its investment or mortality experience. From a policyholder's point of view, the retention by the insurer of such discretion generally permits the insurer to offer the policyholder more favorable contract terms than would be possible without such discretion.* Such arrangements, however, would not be possible if the insurer were precluded from maintaining and exercising such discretion in its own interests.

3. Many general account contracts issued to retirement plans allows the plan to request withdrawals for reasons other than to make benefit payments (e.g., to make other investments), but also permit the insurer, at its discretion, to defer the payment of requested withdrawals under the contract (other than regular benefit payments) during periods of extraordinary negative cash flow in the general account. Such provisions are intended to protect the insurer and its policyholders in the aggregate from the losses and impairment of the insurer's long-term financial condition which might result from a massive liquidation of investments to satisfy withdrawal requests. If,

* To the extent that insurers cannot retain discretion to deal with these risks, they must either offer products . . . **[TEXT CUT OFF ON COPY]**

however, an insurer were a fiduciary, it could be prohibited from invoking such provisions with respect to an employee benefit plan regardless of the interests of its other policyholders.

The retention of contractual discretion by an insurer may carry with it some potential for abuse. However, ERISA's fiduciary responsibility provisions are not the only means, or even the most appropriate means, of protecting employee benefit plans from such abuse Insurance regulation under state law is specifically designed to regulate an insurer's solvency and its conduct so that the interests of all of the insurer's policyholders will be protected and reconciled with each other. Indeed, contracts and policies issued by insurers are filed with and subject to review by state insurance departments before they can be offered to potential policyholders. ERISA, on the other hand, is an inappropriate regulatory scheme with respect to general account operations because it would test the insurer's exercise of its discretion solely with reference to the interests of one group of policyholders, employee benefit plans, to the total disregard of all others, and in some instances one employee benefit plan to the exclusion of all others plans and policyholders.

While the specific state insurance regulations governing insurers vary from jurisdiction to jurisdiction, such regulations generally include the following types of provisions which provide significant protections to employee benefit plan contractholders without ignoring or interfering with the insurer's obligations to its other policyholders:

1. Restrictions and requirements with respect to the investment of general account assets which are intended to assure that the insurer can satisfy all of its obligations. Such restrictions and requirements typically include limitations on the types of investments which can be made with general account assets, requirements with respect to the diversification of investments, and requirements for the maintenance of reserves.

2. Prohibitions against "unfair trade practices" which are generally broadly defined to include misrepresentations concerning the terms of a contract (including misrepresentations concerning the level of dividends or share of surplus to be credited to the contractholder) and other false or misleading sales practices, the exercise of coercion (for example, by making the purchase of an insurance contract a condition for the insurer's extension of credit) or the granting of special favors or inducements in connection with the sales of contracts, or unreasonable or inequitable practices in connection with the administration of contracts.

3. Prohibitions against discriminatory practices, including discrimination in connection with the administration of contracts, the allocation of investment income or dividends among different categories of contractholders or the determination of premiums or other charges.

4. Restrictions on the payment of dividends to shareholders and on transactions by a life insurance company with affiliates.

5. Provisions for the review and approval by insurance departments of contracts and contract amendments.

In addition to the protections afforded by state regulation, general state contract law principles serve to significantly limit any potential for abuse in an insurer's exercise of contractual discretion. In circumstances where an insurer engages in practices that could be viewed as over-reaching or attempts to rely on ambiguous contractual provision, the courts have little difficulty in holding in favor of the contractholder. Where, on the other hand, the provisions of the contract are reasonable and clear, there is no warrant for applying ERISA to transform what should be a state contract law dispute into a federal case.

Given these protections, few, if any, potentially abusive practices by insurers in connection with the management of general account assets or the exercise of discretion under general account contracts which would violate ERISA policy would not be subject to correction or rectification. On the other hand, the substitution of ERISA's fiduciary responsibility provisions for this scheme of state insurance regulation would result in the imposition of a standard of conduct which basically ignores and is in conflict with the best interests of the insurer's constituents who are not employee benefit plans.

In enacting ERISA, Congress did not intend to have ERISA supercede the regulation of insurance companies by the states. Section 514(b)(2)(A) provides that, notwithstanding the general preemption rules of section 514(a), ERISA does not exempt any person from any law that regulates insurance. Moreover, the existence of the states' regulation of insurance companies was an important factor in the Labor Department's determination to create an exception from plan assets treatment for general account assets in its proposed "plan assets" regulation. In the preamble to the regulation, the Department stated:

> The exemption for contracts or policies issued by insurers and funded by insurers' general accounts also appears to be based upon the fact that the plan benefits provided under such contracts or policies are insured by an entity which is subject to state regulation designed to assure the entity's ability to pay benefits specified in the policy when due.

V. Need for Legislation

Because of the uncertainty that has been created by the recent court decisions and the widespread negative impact that these decisions might have, it is essential that the general account contract issue be resolved definitively and, therefore, that it be resolved through legislative action. Sound and clear rules regarding the inapplicability of ERISA's fiduciary responsibility and prohibited transaction provisions to the general account operations of insurance companies are crucial to the entire industry. If applied to general account operations, these provisions would have a materially adverse effect both on the day-to-day management of billions of dollars of obligations under contracts issued to ERISA and non-ERISA contractholders and on the daily investment of hundreds of millions of dollars. The lack of clear rules in this area stems mainly from the ambiguous language of ERISA itself — that is, the ill-defined concept of a "guaranteed benefit policy" in ERISA section 401(b)(2). Thus, only Congress can definitively correct the problem by clarifying the statutory language of ERISA.

Additionally, as experience under ERISA has shown, some courts may be unaware of, or unpersuaded by, agency interpretations

of ERISA, no matter what position the agency takes. Consequently, we believe that any administrative solution would necessarily prove to be inadequate, and that only a legislative solution will fully resolve this issue.

VI. Description of Proposed Legislation

Set forth below is a proposed amendment to ERISA that would clarify that the fiduciary responsibility provisions of ERISA do not apply to the management of general account assets or to the exercise of discretionary rights accorded to insurers under general account contracts. (Parallel changes would, of course, be made to Internal Revenue Code section 4975.)

1. Amend section 3(21) of ERISA by adding a new subparagraph 3(21)(C) at the end thereof, as follows:

> (C) If any money or other property of an employee benefit plan is paid as consideration under a contract issued by an insurer, neither the exercise by the insurer of any of the rights granted to it under such contract, nor the exercise by the insurer of any authority or control respecting the management or disposition of such consideration or any assets acquired by the insurer therewith, shall cause the insurer to be deemed to be a fiduciary under this title. This subparagraph shall not, however, preclude an insurer from being deemed to be a fiduciary to the extent that —
>
> (i) the insurer is acting as the appropriate named fiduciary of such plan pursuant to section 503 of this title,
> (ii) the insurer is exercising authority or control with respect to functions for which it has acknowledged in writing that it is a fiduciary with respect to such plan or the "administrator" of such plan (within the meaning of paragraph (16) of this section), or
> (iii) the insurer is exercising authority or control respecting the management of disposition of consideration paid by such plan or any assets acquired by the insurer therewith which has been placed in a separate account of the insurer and which remains an asset of the plan pursuant to section 401(b)(2)(B) of this title."

2. Amend section 3(21)(A) to strike the phrase "subparagraph (B)" and insert in lieu thereof "subparagraphs (B) and (C)".

3. Amend section 401(b) of ERISA by amending section 401(b)(2) to read as follow:

"(2)(A) If an insurer issues a contract to a plan and the consideration for such contract is placed in its general account, the assets of such plan shall be deemed to include such contract, but shall not be deemed to include the consideration placed in the general account or any assets acquired by the insurer therewith.

(B) If an insurer issues a contract to a plan and the consideration for such contract is placed in a separate account, the assets of such plan shall be deemed to include such contract, but shall not be deemed to include —

(i) any surplus in such separate account, or
(ii) any consideration placed in such separate account or any assets acquired by the insurer therewith if the separate account is maintained by the insurer solely in connection with fixed contractual obligations and if neither the amount payable or credited to the plan nor to any participant or beneficiary in the plan is affected in any way by the investment performance of the separate account.

(C) For purposes of this paragraph;

(i) The term "insurer" means an insurance company, insurance service, or insurance organization, qualified to do business in a state.
(ii) The term "general account" means those assets owned by an insurer which are not held in a separate account, and which, in the event of the insolvency of the insurer, will not be segregated for the benefit of particular policyholders of the insurer.".

American Council of Life Insurance

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Stephen W. Kraus
Associate General Counsel

May 18, 1984

TO: Pension Committee

Enclosed, as approved by your Chairman, is a copy of the minutes of the April 19, 1984, meeting of the Pension Committee.

Sincerely,

Stephen W. Kraus

SWK/jsg
Enclosure

The meeting convened at 10:00 a.m.

The following members were present:

Donald H. Pond, Jr., Chairman
Herbert J. Boothroyd
Yuan Chang
Gilbert F. Cronin
Peter Cross
William Cunningham
William F. Gould
E. Thomas Hughes
Elliot Kassenoff
David J. McDonald
John M. Naughton
Russell H. Smith, Jr.
Henry N. Winslow

The following members were unable to attend:

Theodossios Athanassiades
William L. Cassidy
Richard C. Higgins
Robert M. McDonough
Kenneth R. O'Brien
William C. Prouty

Others present during all or part of the meeting were:

Melvin B. Altman, Equitable
Bethany Alvord, Massachusetts Mutual
John Booth, ACLI
Douglas Clark, Connecticut Mutual
Regina Fink, Lincoln National
Stephen H. Goldberg, Aetna Life & Casualty
Marcia Henderson, New England Life
P. Scott Hutton , ACLI
David Kalib, Berkshire Life
Richard Kaplan, Phoenix Mutual
Stephen W. Kraus, ACLI
James McQueston, National Life of Vermont
Sara Moonin, New England Life
Maureen Mullen, CIGNA
Roger Napoleon, New York Life
Saul Pearlman, Acacia Mutual
Robert Prensner, New England Life
Ronald Powell, IDS Life
Barrett N. Sidel, CIGNA
John Schmidt, Connecticut Mutual

Gerard Talbot, Metropolitan
Andrew Watson, MONY
Edward Zimmerman, ACLI

Report of the Fiduciary Matters Task Force

General Account Problems. The Committee was reminded that ever since the enactment of ERISA, there has been concern within the business regarding the treatment of an insurance company's general account contracts and assets and the potential application of ERISA's fiduciary responsibility provisions and prohibited transactions rules to such contracts and assets.

The Committee was further reminded that initially, the issue focused on whether general account assets were "plan assets". The Department of Labor and IRS very early took a favorable position with regard to this issue in IB 75-2 stating that if an insurance company issues a contract or policy of insurance to a pension plan and places the consideration for such contract or policy in its general asset account, the assets in such account shall not be considered to be plan assets. It was reported that the Council legislative position had been to seek codification of this rule.

Recently, however, the 7th Circuit Court of Appeals held in two cases that insurance companies that issue contracts to employee pension benefit plans may be fiduciaries when they exercise certain rights under those contracts (Chicago Board Options Exchange v. Connecticut General Life Insurance Co.), or in the management of amounts deposited in the general account of the insurer under the contracts (Peoria Union Stock Yards Company Retirement Plan v. Penn Mutual Life Insurance Co.), or both.

As a result of these cases, the Task Force recommended, and the Committee, as a result of a telephone poll, agreed, that a legislative change to ERISA would be the most appropriate course to follow. The Committee further agreed that such legislative change should be much broader than the current Council position and should seek the following:

1. An amendment to ERISA to clarify that an employee benefit plan's investment in a contract issued by an insurer does not cause such insurer to be deemed to be a fiduciary, except insofar as the deposits under such contract are "plan assets"; and

2. An amendment to ERISA to clarify that amounts deposited under a contract issued by an insurer in the insurer's general asset account shall not be considered to be "plan assets."

The Committee was advised that the President of the Council and two Chief Executive Officers from member companies had met with Secretary of Labor Raymond Donovan to stress the importance of the issue to the life insurance business and to urge prompt and serious consideration of our legislative approach by the Labor Department. The Committee was informed that it had been determined that before any legislative effort with the Congress would be undertaken, the Council should make a serious and concerted effort to obtain Labor Department approval, or at least non-opposition, to the Council's legislative approach.

It was reported that Secretary Donovan had stated that he wants to avoid ERISA legislation because of his concern that once an ERISA bill is introduced, attempts would be made to expand the bill by others who believe they have ERISA problems. It was further reported that Secretary Donovan had indicated that he would prefer to solve our problem administratively, if at all possible. The Committee was advised that the industry representatives told Secretary Donovan that in our view the problem did not lend itself to an administrative solution and that legislation was necessary.

The Committee was further informed that after the meeting with Secretary Donovan, another meeting was held between Department of Labor staff, including the Administrator of the Department's Pension Program, Robert Monks, and the Solicitor of Labor, Frank Lilly, and Council staff and industry representatives. At this meeting, the Council's proposal was discussed in greater detail. The Labor Department representatives took our proposal under advisement and indicated that they would get back to us quickly with a response. The Committee was advised that once agreement is reached with the Labor Department, the proposal would be referred to the Cabinet

Council of Economic Advisors that deals with Pension Policy for final approval.

New York State Insurance Department Letters on Group Annuity Contracts. It was reported that the New York Insurance Department had issued, and is continuing to issue, letters to member companies relating to group annuity contracts. It was further reported that the New York Department has adopted two rules. The first provides that for contracts funding defined contribution plans, withdrawals from such contracts' guaranteed account for the purpose of providing plan benefits relating to death, disability, retirement or termination of employment must be made at book value. The second rule provides that a guaranteed benefit contract must provide a guarantee of principal, interest and repayment, i.e., no market value adjustment.

The Committee was informed that serious concern was expressed about these letters, particularly the views of the New York Department relating to the nature of group annuity contracts and the appropriateness of their use in the qualified plan market. The Committee was further informed that the Chairman of the Life Insurance Council of New York (LICONY) had appointed a special committee to deal with this issue.

It was reported that the Task Force decided that the issue is significant enough to warrant Council participation. As a result, a meeting is being planned between the Deputy Insurance Superintendent of New York and his staff and representatives from LICONY, the Council and the industry. At this meeting, the industry will protest the procedures used by the New York Department in issuing these letters and will try to get the Department to pull back their letters. The Committee unanimously approved the course of action outlined by the Task Force.

Final "Qualified Professional Asset Managers" Class Exemption. Finally, it was reported that the Labor Department had recently issued Prohibited Transaction Exemption 84-14 for plan asset transactions determined by independent Qualified Professional Asset Managers (QPAM). QPAM permits various parties who are related to employee benefit plans to engage in transactions involving plan

assets, if among other conditions, the assets are managed by "Qualified Professional Asset Managers" which are independent or such parties-in-interest and which meet specified financial standards. The exemption is retroactive to December 21, 1982.

The Committee was informed that the final exemption contains many of the changes advocated by the Council and others when the exemption was first published and at the public hearing to discuss the proposal.

Report of the Task Forces on Small Cases and Plan Design

Use of Universal Life in Qualified Pension Plans. The Committee was reminded that at its last meeting it had approved a recommendation of the Small Case Task Force regarding the use of universal life and other "non-traditional" insurance contracts in qualified defined contribution pension plans. The Committee was further reminded that the Council is proposing a two-part test to the Internal Revenue Service.

The basic test will allow a company to use its net term charge determined within the universal life, or other non-traditional, contract to test for "incidentalness". In addition, a safe harbor is being recommended. The safe harbor consists of Non-Smoker, Smoker and Combination Tables by age at entry showing per $1,000 of annual plan contribution (1) the maximum level amount at risk; (2) the maximum level death benefit and (3) the required age 65 cash value.

The Committee was informed that Council staff, together with industry representatives, had met with representatives of the Internal Revenue Service to discuss our proposals and had filed a memorandum with the Service setting forth our approach and the rationale behind it. The Committee was further informed that the IRS representatives did not appear to be too receptive to the Council's 25 percent rule, the principal problem being its susceptibility to manipulation. The IRS representatives did indicate some interest, however, in the safe harbor table.

It was reported that while the Service had not formally responded to the Council's submission, it had dealt with this issue in connection with the recently issued Revenue Procedure (Rev. Proc. 84-23) on master and prototype plans. As part of its List of Required Modifications (LRM), the Service had set forth its view as to how universal life could be used in a qualified defined contribution plan.

The Committee was informed that the Task Forces, at their meeting yesterday, concluded that the Council should file a strong letter of protest with the IRS. The Task Forces believe that rule making through a procedural mechanism such as a List of Required Modifications is highly inappropriate, particularly when an industry proposal dealing with the issue is pending before the Service. In addition, if a rule different from that set forth in the LRM is adopted, a correcting amendment will be necessary very soon after master and prototype sponsors have undertaken the burden of restating their plans in accordance with Rev. Proc. 84-23. The Committee agreed with the recommendation of the Task Forces.

TEFRA Amendments—Procedures for Master and Prototype Plans. It was reported that the Task Forces also reviewed Revenue Procedure 84-23 which sets forth the TEFRA amendment procedures that will be applied to sponsors of master and prototype plans and to their adopting employers. The revenue procedure reflects many of the suggestions offered by the Council when staff discussed the TEFRA transition problem with the Service last year. The Committee was informed, however, that the Task Forces were very concerned about the inability of employers who wish to adopt master or prototype plans after the effective date of the procedure to utilize the special reliance procedure set forth therein. Moreover, the ability of previously adopting employers to rely on the reliance procedure was not clear to the Task Forces. As a result, the Task Forces concluded that the Council should file a letter with the Internal Revenue Service requesting clarification and expansion of the scope of the special reliance procedure. The Task Forces also determined that the Council should urge the Service to expend the revenue procedure to allow more employers who adopt a standardized form plan, as defined in the revenue procedure, to utilize the simplified approval process set forth therein. The Committee approved the Task Forces' recommendations.

ERISA Advisory Council

The Committee was informed that the Council had testified before the Department of Labor's ERISA Advisory Council on Employee Welfare and Pension Benefit Plans. The Committee was further informed that the Council's testimony dealt with the impact of ERISA and related legislation on pension and other employee benefit plans. In particular, the testimony stressed our concern with the escalating costs of plan administration as a result of new legislation and regulation and the problems the life insurance business has had, and continues to have, with the fiduciary responsibility and prohibited transaction provision of ERISA. Finally, our testimony indicated that we must develop a national policy on private pensions and that we cannot continue to have major legislation affecting pensions enacted on an ad hoc, revenue driven, basis almost every year.

Pending Litigation

Tax Reform Legislation—Proposed Pension Changes. It was reported that the Deficit Reduction Act of 1984, which was recently passed by the Senate, contains numerous pension provisions, many of which are modifications of the TEFRA top-heavy rules. In particular, the pension provisions include a repeal of the super top-heavy rules enacted by TEFRA and an additional two-year cost-of-living freeze on the dollar limits under section 415 of the Internal Revenue Code. (The cost-of-living freeze is also in the Tax Reform Act of 1984 which has been passed by the House.) The Act would also provide a special 1.4 rule under section 415 for companies with plans that are neither top-heavy nor integrated with Social Security and would add a 25% deduction limitation for employers that maintain both a money purchase pension plan a defined pension plan. (This limitation currently applies only to employers that maintain both a defined benefit and a defined contribution plan.) Finally, the Act would limit deductions to 100% of the current compensation of covered plan participants.

The Committee was informed that a coalition has been formed to develop a compromise, revenue neutral, proposal regarding the provisions mentioned above. Under the compromise, the following

changes would be made in the pension provisions of the Deficit Reduction Act:

(1) In lieu of eliminating the super top-heavy rules, the super top-heavy definition would be modified to limit super top-heavy plans to plans in which 98% or more of the benefits are for key employees;

(2) The 25% deduction limit would be eliminated;

(3) The two-year freeze on the cost-of-living increases in section 415 would be eliminated;

(5) The existing 10 years of service requirement in section 415(b)(5) (i.e., 10 years of service is required in order to be entitled to the full benefits under section 415) would be modified to also require 5 years of plan participation in order to qualify for the full dollar limitations under section 415.

The Committee discussed the proposed changes in the Senate bill and the possible compromise. The Committee agreed that enactment of the additional two-year cost-of-living freeze on the section 415 limits and the addition of the 25% deduction limitation for employers maintaining more than one pension plan would have a serious adverse impact, particularly in the small plan area. The Committee unanimously agreed that the Council should add its name to the list of organizations endorsing the compromise and should engage in low key lobbying efforts in an attempt to get the compromise adopted during the conference on the tax bills.

Pension Equity Legislation. It was reported that the House Ways and Means Committee had recently passed its version of a pension equity bill. The Ways and Means bill makes several modifications to the version of the legislation that was approved unanimously by the House Education and Labor Committee last November. In addition, the legislation is somewhat different from the pension equity legislation approved by the Senate last year.

Staff reported on some of the principal differences and similarities in the two House bills. The bills, as approved by both House

panels, would lower the minimum age for plan participation from 25 to 21. However, the Ways and Means version would not provide the optional "lookback" rule for defined benefit plans that was approved by the Labor Committee. The "lookback" rule would allow defined benefit plans to continue to use age 25 as the participation age only if, when the employee reaches age 25, he or she is credited with service from age 21 on for benefit accrual purposes.

The Committee was informed that provisions approved by the Ways and Means Committee dealing with the minimum vesting age, breaks in service, and maternity/paternity leave were the same as those approved by the Education and Labor panel.

The Ways and Means bill would provide for a separate pre-retirement survivor annuity for cases involving death of a participant prior to attainment of normal retirement age under the plan. Pre-retirement survivor coverage would become automatic when a participant has any vested accrued benefits under the plan. As approved by the Labor Committee, the bill would require pre-retirement survivor coverage only when a participant reaches the earliest retirement age under the plan and is 120 months from normal retirement age, or has 10 years of service. Under both bills, spousal consent would be required before a participant could decline a joint and survivor annuity.

The Committee was informed that pension equity legislation would be enacted during this session of Congress.

Risk Classification Legislation. Staff reported that on March 28, the House Committee on Energy and Commerce agreed to ACLI and industry supported amendments offered by Representatives Dowdy (D-MS)/ Lent (R-NY) and Representative Tauzin (D-LA) to H.R. 100, the "Nondiscrimination in Insurance Act".

It was further reported that the Tauzin amendment carves out individual lines of insurance from the bill and creates a Commission "for the purpose of studying what Federal legislation might be appropriate in order to regulate insurance not part of an employee benefit plan." The Dowdy/Lent amendment exempts all existing insurance contracts and clears up a number of other problems in the

original draft of H.R. 100. These provisions were adopted in place of an amendment proposed by Representative Florio (D-NJ) which would have exempted existing individual life insurance policies and to a lesser extent existing individual annuity contracts. However, the proposed Florio amendment would not have addressed many of the other problems raised by the original draft of H.R. 100. H.R. 100 as amended was then agreed to by voice vote and ordered reported from the Energy and Commerce Committee.

The Senate counterpart (S. 372) had been held in committee awaiting a report from the General Accounting Office. The report was issued on April 6, 1984. While the report does not fully support either the industry or the proponents, it does raise crucial issues, such as potential unfunded liabilities, the exclusion of existing individual contracts, and the need for an extended effective date.

The Committee was informed that given the short amount of time remaining in this session of the Congress and these developments, further action in either house appears unlikely this year.

Staff also reported on the extensive activity on the state level. Bills requiring "unisex" insurance were defeated in California, Maryland, Missouri, New Mexico, Oklahoma, Vermont, Washington, and West Virginia. Bills are currently pending in the District of Columbia, Massachusetts, Michigan and New Jersey. A hearing has been scheduled in Michigan on May 16, 1984, and a mark-up session has been set for May 2, 1984, in Massachusetts. The industry is mounting an effort to repeal or modify the Montana law which is to be effective October 1, 1985.

Reversion of Assets

The Committee was informed that much consideration has been given recently to the reversion of assets to pension plan sponsors in over-funded defined benefit pension plans. At present, such assets can be recovered by the sponsoring employer only upon plan termination. Consequently, a number of plan terminations have occurred where the apparent principal motivation was the recovery of excess assets.

It was reported that Congress has focused its attention on this issue, and several possible solutions are being discussed. One solution would prohibit the recovery of excess assets upon plan termination. A second would limit the definition of what is a plan termination. In addition, consideration is being given to trying to set a moratorium on the termination of pension plans involving reversions of excess assets to employers.

The Committee engaged in considerable discussion regarding this issue. One member expressed the view that permitting sponsoring employers to recover excess assets could result in a serious asset drain on life insurance companies since there would be considerable pressure to have book value cash-outs. In addition, this member felt that such a policy would accelerate an already undesirable trend away from defined benefit plans to defined contribution plans which would not be in the best interests of plan participants. Finally, this member thought that if we supported legislation prohibiting the reversion of plan assets to sponsoring employers, we would improve our public image with Congress and those groups representing plan participants. Those expressing a contrary view argued that the establishment of a pension plan is purely voluntary on an employer's part. Similarly, an employer is generally free to terminate his plan and should be entitled to any surplus after the participants' accrued benefits have been fully vested and annuitized. Such a rule would benefit not only employers and plan participants, but our members as well since it would result in more annuities being purchased.

The Committee was informed that the Administration's position on this issue is that reversions should be permitted if annuities are purchased for vested participants. However, the Administration recognizes that there are problems with certain current administrative procedures involving (1) cash-outs, (2) when a defined benefit plan is terminated and a new defined benefit plan is established and (3) spinoffs, i.e., when an employer separates his plan into two plans and terminates one of those plans.

The Committee agreed to establish a working group to examine the issue and develop a council position.

Open Questions on Employee Benefits After 1984 Legislation

The Committee was informed that employee pension and welfare benefits are coming increasingly under legislative attack. The Committee was further informed that despite the several provisions in the pending tax legislation dealing with employee pension and welfare benefits, many questions remain unresolved. Congress continues to focus its attention on the increasing amount of an employee's salary that is being used to purchase tax-favored benefits. One of the principal Congressional concerns is the annual cost to the Federal government. In addition, there is concern about whether a broad enough cross section of employees is receiving these benefits so as to justify the cost.

It was reported that either this fall or early next year hearings will likely be held on the general question of employee benefits. The hearings will probably focus on the value of such benefits to society and the price that should be paid by the Federal government in providing such benefits. There is a possibility that legislation will be introduced to limit either the types and/or the amounts of employee benefits that will be allowed to be provided on a tax-favored basis in the future.

The Committee generally discussed the issue. The Committee was informed that the Group Insurance Committee had also discussed this issue at its last meeting and had agreed to establish a special Task Force to explore the seriousness of the Congressional concern and develop an industry response. The Committee agreed with the Group Committee's approach and authorized the Chairman to establish a group to analyze the problem from the pension perspective.

Parity in the Treatment of IRAs and DECs

A member asked the Committee to consider a proposal it had developed for parity in treatment between IRAs and Deductible Employee Contributions to qualified plans (DECs). The company argued that Congress, in expanding individual retirement accounts and allowing DECs intended to allow maximum flexibility and ease of access for the individual and competitive parity among financial institutions. The Committee was informed that the legislative history

of the Economic Recovery Tax Act indicates that these two retirement savings vehicles were intended to have parity in treatment.

In was pointed out that under present law, IRAs cannot be rolled over into DECs while any portion of the account accumulated in a DEC can be rolled over tax-free into an IRA. In addition, while present law permits spousal IRAs to be established for non-working spouses, spousal DECs are not permitted. Under the pending tax legislation, the maximum deduction a married couple may take for retirement saving through IRAs will greatly increase while such increase will not be available for employees who decide to use the DEC approach. Finally, the proposal to allow non-deductible contributions up to $1,750 to IRAs would not extend to DECs.

During the discussion of this issue, it was pointed out that the Congressional staffs consider this problem to be fairly narrow, and therefore, it has been difficult to get people to focus on it. The Committee agreed that in view of all the other issues currently facing our industry, parity between IRAs and DECs is a low priority item. The Committee agreed to support the concept of parity in principle, but indicated that staff should not spend a significant amount of time dealing with it.

The meeting adjourned at 1:30 p.m.

U.S. Department of Labor Office of Pension and Welfare Benfit Programs
Washington, D.C. 20210

June 1, 1984

Mr. Richard Minck
American Council of Life Insurance
1850 K Street, N.W.
Washington, D.C. 20006

Dear Mr. Minck:

I enjoyed meeting with you and other representatives of the insurance industry to discuss your concerns regarding the treatment under ERISA of insurance company general account contracts and your proposed legislative solutions. I regret that the press of other business has delayed my response to you.

While I can appreciate the problems that were outlined, the Department is not prepared, at this time, to support legislation dealing with these issues. As you may know, some time ago we requested from representatives of members of the industry information regarding the different types of general account products which insurance companies offer, so that we could better understand the situation which you have presented to us. After we receive this information, and we have reviewed it, we would be in a better position to meet with you to discuss how best to handle the issues raised.

I am very hopeful that we can move quickly to a position on this question. We will arrange the necessary meetings after we have reviewed the information you provide.

Again, I enjoyed our meeting and hope we can find some mutually agreeable way of dealing with these issues.

Sincerely,

Robert A.G. Monks
Administrator

Meeting March 5, 1985 Between American Council of Life Insurance and Department of Labor Regarding the ACLI general account Legislative Proposal

Morton Klevan	Department of Labor
Bob Eccles	Department of Labor
Elliot Daniel	Department of Labor
Bill Schmidt	Department of Labor
Jean Leahy	Department of Labor
Steve Kraus	ACLI
Larry Hass	Groom and Nordberg
Ted Groom	Groom and Nordberg
Bill Harman	Davis & Harman
Mel Altman	Equitable
Alan D. Lebowitz	Department of Labor
Stephen H. Goldberg	Aetna Life and Casualty Co.
Jacquie Abbott	Lincoln National Corporation

Steve Goldberg opened the meeting by briefly outlining the events which lead up to the meeting. He referred to the submission by the Council in March 1984 which set forth our legislative proposal together with a detailed memorandum supporting the proposed legislation and the June 1984 response from Mr. Monks, in which the Department of Labor indicated that it was not prepared to comment on our legislative proposal until the Council responded in greater detail, describing our general account contracts and how an insurance company's general account operates. Steve Goldberg reminded the Labor Department representatives that Mr. Monks' letter further indicated that once the Council responded, the Labor Department would work with us quickly to reach a satisfactory resolution of the issue. Steve Goldberg then indicated that the Council, late in 1984, filed a detailed letter with the Labor Department responding to Mr. Monks' requests and that we were here today to answer any questions the Department of Labor representatives had with respect to that letter or the issue generally.

The representatives from the Department of Labor were made aware that resolution of the question of whether an insurance company's general account assets were plan assets is a critical issue to the insurance industry which must be dealt with urgently. A major reason

cited was the uncertainty created by the Peoria Union Stockyards and CBOF cases. We indicated that the need for clarification was further increased by the Labor Department's recent promulgation of the proposed plan asset regulations in that more uncertainty was created as a result of the preamble language which indicated that IB 75-2 would be withdrawn when final regulations dealing with plan assets were promulgated.

Bob Eccles asked whether we could characterize the group annuity market today versus the group annuity market that existed in 1974. We responded that except for GIC's, the products in the group pension market today have not changed significantly from those that were issued in 1974 and before. Bob Eccles asked whether new deposit administration and IPG business is currently being written and we responded that the answer varied depending on the company and the market being serviced.

Morton Klevan then asked whether segmentation was a practice that was being utilized in 1974. We indicated that segmentation was a fairly new development which came into existence during the last 4 years, but that the investment year method did go back to 1974 and that segmentation is just a refinement of the investment year method. We indicated that under segmentation, assets were identified only for investment income allocation purposes and that even if a company was utilizing segmentation to allocate investment income, all assets in the general account still stood behind all general account liabilities.

A question was then raised as to the difference between a contract written from the separate account versus the practice of segmentation in the general account. We indicated that contractholders in the separate account were only entitled to a pro rata return of whatever the assets in the separate account were worth. With regard to general account contracts, even with segmentation, the contractholder was always entitled to something more than a pro rata return on the assets in the segment.

Morton Klevan then asked whether all general account contracts have guarantees of principal and interest. We responded that there were a wide variety of types and levels of guarantees, but that under all general account contracts, principal would not be reduced if it were

left with the insurance company to pay benefits, even if the insurance company experienced adverse investment results. We also indicated that certain withdrawals would not result in a reduction of principal, such as, withdrawals to purchase annuities or installment payout. With regard to market value adjustments, we indicated that the MVA merely measures the difference between the current investment yield and the yield at the time of the investment.

We then made the point to the Department of Labor representatives that focusing on a continuum of contracts does not solve the problem and by doing so, one looses the focus of the nature of an insurance company's general account. We reiterated that the primary business of an insurer is not the investment of capital but rather the assumption of risks and other functions that are not investment related. We indicated that the Labor Department in its proposed plan asset regulations appeared to adopt the rationale that if a plan invested in an operating company, the underlying assets of the operating company were not plan assets. We indicated that has same rule should apply to a plan that invested in an insurance company's general asset account.

A question was then raised about universal life and Bill Harman gave a brief description of how the contract operated. He indicated that it was a flexible premium contract with a cash value equal to the contributions to the policy, less a certain load. He further indicated that a typical universal life contract guaranteed 4% to 5% interest and that most contracts had an excess interest guarantee, which lasted anywhere form 1 to 3 years. Finally, he mentioned that universal life contracts guarantee a maximum mortality charge.

Morton Klevan then offered his understanding of segmentation. He wanted to know whether he was correct in assuming that segmentation was an attempt to make a general account contract look more like a separate account contract when there was favorable investment experience, but protected the policyholder in the event there was unfavorable investment experience. We indicated segmentation was not being used as a marketing took, but merely to allocate investment income within the general account. We also indicated that segmentation was not a universal practice and that different companies had different ways of segmenting their general accounts.

Morton Klevan then asked if it was possible for an insurance company to issue a general account contract that would provide more than the policyholder's participation in a pro rata portion of the investment performance of a particular segment, such that the contract would operate no differently than a separate account contract. We initially indicated that our survey did not reveal that this type of contract was being offered by any insurance company. Secondly, we indicated that it might be disadvantageous or impossible to offer such a product because of tax or state insurance considerations. We indicated further, however, that if this was his primary concern we certainly would be willing to work with him to reflect that concern in our legislative proposal.

Finally, Alan Lebowitz gratuitously offered the comment that the Labor department generally moves very slowly when they are considering an issue on their own. He indicated, however, that the Department responds much more quickly when there is an outside stimulus, i.e. a Congressional request. we indicated that we understood Mr. Leobwitz's point and would be meeting to decide how we could address it.

The meeting ended with a request from the ACLI representatives to meet again within the next 4 weeks. The Department of Labor representatives did not commit to such a meeting.

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006-2284
(202) 862-4191

Stephen W. Kraus
Associate General Counsel

May 17, 1985

TO: GENERAL ACCOUNT LEGISLATIVE STRATEGY GROUP

This is to confirm that the next meeting of your group will be on May 28, 1985. The meeting will be held in the Asian Room of the International Club, 1800 K Street, NW, beginning at 10:00 a.m. The International Club has an entrance on 18th Street between K and Eye Streets and it would be easier if you entered through the 18th Street entrance.

The primary purpose of the meeting is to discuss what action the Council should take in view of the Labor Department's response to our legislative proposal. As you know, the Labor Department has rejected our legislation and has suggested instead that legislation be drafted that would: (1) treat general account contracts similar to any other investment a plan makes so that a determination would have to be made as to whether a plan which purchases a general account contract is purchasing a debt or equity interest; and (2) require insurance companies to disclose to a prospective purchaser the key features of the contract he is interested in purchasing including, among other things, a description of what would happen upon a premature termination of the contract.

It has also been suggested that the Council write to new Secretary of Labor Brock, setting forth our view of the urgent need for legislation and requesting a meeting with him as quickly as possible. You should be prepared to discuss whether the Council should pursue this course of action.

Sincerely,

Stephen W. Kraus

/ha

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006
(202) 862-4000

June 28, 1985

DESCRIPTION OF MODIFIED ERISA LEGISLATION

Background

In February, 1984, the Council's Legislative Committee voted to actively seek legislation which would clarify that an insurance company is not an ERISA fiduciary in connection with the management of its general account assets or the exercise of discretion accorded to it under general account contracts. The need for such clarification stems both from an ambiguity in the current language of ERISA and two 1983 decisions of the Seventh Circuit Court of Appeals which held that an insurance company was a fiduciary with respect to the management of consideration allocated to its general account under a deposit administration contract (Peoria Union Stock Yards Company Retirement Plan vs. Penn Mutual) and that an insurance company was a fiduciary with respect to its exercise of discretion to unilaterally amend a group annuity contract (Chicago Board Options Exchange v. Connecticut General). While these decisions relate to group annuity contracts, their reasoning is equally applicable to other types of contracts issued in connection with employee pension and welfare benefit plans. The severe consequences of the application of ERISA's fiduciary responsibility and prohibited transaction provisions to general account operations were outlined in a position paper prepared in connection with the Council's proposed The Council has been informed by several members of Congress and their staffs that Department of Labor support is critical to the successful enactment of any legislation which would resolve the ERISA status of general account assets and general account operations. Consequently, several meetings have been held by the Council with the Department over the past year (including a meeting in March, 1984 with then Secretary of Labor Donovan), a detailed memorandum was prepared by the Council in December, 1984 for the Department, at its request, describing general account operations and general account contracts, and a letter was recently sent to Secretary

of Labor Brock for Senators Dodd and Nickles urging that the Department work with Congress and representatives of the insurance industry to devise a legislative solution.

Recently, members of the career staff of the Department's Office of Pension and Welfare Benefit Programs have informed industry representatives and members of Senators' Dodd and Nickle's staff that they regard the Council's current legislative proposal as unacceptable. However, they have expressed a willingness to work with the industry and representatives of Congress to develop mutually satisfactory legislation in this area, and have informally outlined the most significant concerns which they believe a legislative proposal must address in order to gain support from the Department.

Summary of DOL Concerns

The Department's staff appears to agree with the industry that as a general rule consideration received by an insurance company under general account contracts should be excluded from "plan asset" status, and that an insurance company's exercise of discretion accorded to it under a general account contract should be excluded from ERISA's fiduciary responsibility provisions. However, unlike the Council's current legislative proposal, the staff has expressed the position that exceptions to the general exclusion from "plan asset" status need to be made in the case of non-traditional contracts which are essentially indistinguishable from non-guaranteed separate account arrangements, and in the case of companies that are not undertaking real insurance risks as a substantial part of their business. While the staff has not made this point explicit, it would appear that the exceptions which they have in mind would not be applicable to most forms of current annuity, health, life insurance and guaranteed interest contract arrangements which contain at least some form of minimum guarantee of investment performance (i.e., guarantees of principal or interest, or guarantees that benefits will not be reduced as a result of adverse investment experience) or to companies, a majority of whose business is comprised of contracts involving such minimum guarantees. The Department's staff also has expressed a serious concern that any broad exemption of insurance company general account operations from ERISA should not leave employee benefit plans without a federal right to seek consequential damages in the

event of an insurance company's commission of fraud or an insurance company's abuse of its discretion to unilaterally amend or otherwise modify the provisions of its contracts. Additionally, the staff has implied that its willingness to support a broad based exclusion of general account assets from "plan assets" status might be conditioned upon the application of a prudence standard to an insurance company's investment of consideration under a general account to the extent that the contractholder participates in the company's investment experience. The staff has acknowledged that any new federal standards governing discretionary contractual amendments and general account investments, unlike ERISA's exclusive benefit rule, would have to take into account an insurance company's obligations to its non-employee benefit plan contractholders and its other reasonable business objectives.

Description of Modified Legislative Proposal

The attached outline has been drafted by an ad hoc working group of the Council's Task Force on Fiduciary Matters in an effort to determine whether a legislative approach could be developed which is both generally responsive to the concerns of the Department's staff and acceptable to the industry. As noted above, meetings which have been held to date with representatives of Congress and their staffs indicate that an effort to address the Department of Labor's legitimate concerns will be an essential element for developing and maintaining Congressional support for the industry's legislative initiative.

The modified legislative proposal which is described in detail in the attached outline is intended generally to address the concerns expressed by the Department's staff, but on a basis most consistent with the industry's primary objectives and concerns. It should be emphasized, however, that this proposal has not been reviewed with the Department's staff and that there is no certainty that the staff, or the policymakers of the Department, or the members of Congress or their staff would find all or material parts of this proposal to be acceptable. The proposal includes the following primary features:

> A general rule which provides that the general account assets of an insurance company are not plan assets and that an insurance company is not a fiduciary with respect to the

exercise of discretion accorded to it under general account contracts.

Exceptions to the general rule for contracts lacking minimum investment guarantees and for companies, a majority of whose general account business is comprised of contracts falling under the exception [This exception is intended to apply only to contracts where the amounts and benefits payable under such contracts are determined solely with reference to the insurance company's investment experience and is not intended to apply to current forms of general account annuity, life insurance and health insurance contracts containing at least minimum investment guarantees, including IPG contracts and universal life].

An anti-fraud provision (patterned after SEC Rule 10b-5) applicable to material misrepresentations and omissions made in connection with the solicitation of consideration under a general account contract. [This provision is not intended to apply to any contract subject to the anti-fraud provisions of the federal securities law or to contracts which do not contain significant investment participation features (e.g., traditional life and health insurance contracts, guaranteed interest contracts without provisions for excess interest)].

A provision creating a federal remedy for damages resulting from an insurance company's unilateral amendment or modification of a contract on an arbitrary and capricious basis. [The "arbitrary and capricious" standard would take into account the insurance company's reasonable business objectives, obligations to other contractholders and applicable state insurance law requirements. Further, no action could be brought where an amendment or modification applies only prospectively to new consideration received after the amendment or where the contractholder is afforded the right to terminate or discontinue the contract on a book value lump sum or installment basis].

A provision which applies a prudence standard to the investment of consideration received under a general account contract. [This standard would not apply to the consideration received under a contract to the extent that amounts or benefits are guaranteed under the contract (e.g. it would not apply to the investment of consideration under a guaranteed interest contract). Further, the prudence standard would be satisfied if, in investing the consideration received under a contract, the insurance company (taking into account the other obligations which its investments support, its corporate objectives, and applicable state insurance law requirements) gives appropriate consideration to its obligations under the contract].

Application of the exception from the general exclusion from ERISA and application of the new anti-fraud, contract amendment and prudence provisions only to contracts issued after the effective date of the legislation; and a provision which would preclude any clause of action being brought against an insurance company on the grounds that the insurance company was a fiduciary by virtue of its management of general account assets or its exercise of discretion under general account contracts prior to the enactment of the legislation.

In summary, the modified legislative approach, like the Council's current legislative proposal, would provide for a general exclusion of general account operations from ERISA's fiduciary responsibility and prohibited transaction provisions in the future and for broad immunity from litigation for alleged breaches of fiduciary duty in the past. However, in an effort to address the concerns of the Department's staff, it would create a limited exception to the general ERISA exclusion on a prospective basis, and would create federal remedies on a prospective basis for violations of certain standards of conduct that are intended to be compatible with how insurance companies now conduct their general account operations.

MINUTES OF THE MEETING OF
THE PENSION COMMITTEE HELD AT
THE COUNCIL'S OFFICES, WASHINGTON, D. C.,
October 9, 1985

MINUTES OF THE MEETING OF
THE PENSION COMMITTEE HELD AT
THE COUNCIL'S OFFICES, WASHINGTON, D. C.,
October 9, 1985

The following members were present:

Jack Naughton, Chairman	Elliott Kassenoff
Herbert Boothroyd	David J. McDonald
Yuan Chang	William C. Prouty
William Cunningham	Russell H. Smith, Jr.
William Gould	Henry N. Winslow
Tom Hughes	Anne Rodier

Others present during all or part of the meeting were as follows:

Mel Altman, Equitable
Jacquie Abbott, Lincoln National
Michal L. Bobryk, Home Life
John Booth, ACLI
Wallace Campbell, State Mutual
Peter Connell, Aetna Life & Casualty
Phyllis Gerstell, ACLI
Steve Goldberg, Aetna Life & Casualty
Bill Gibb, ACLI
Ken Cohen, Massachusetts Mutual
John Hicinbothem, New England Life
Steve Kraus, ACLI
Lawrence J. Hass, Groom & Nordberg
David Levy, O'Neill & Haase
Ken Meuser, Meuser Associates
Gordon J. Munro, New York Life
Michael M. Oleske, Metropolitan Life
Ron Powell, IDS Life
Mike Romig, ACLI
Steve Sacher, Pepper, Hamilton & Scheetz
John Schmidt, Bankers Life
Thomas F. Shea, CIGNA Corporation
Tony Spano, ACLI
Tony Valanzano, ACLI

Chairman Naughton began the meeting at 10:00 a.m. The first item on the agenda was a report, given by Steve Goldberg, Chairman of the Pension Committee's Fiduciary Task Force, on the progress of efforts to seek legislative clarification of the fiduciary status of insurance companies in connection with general account operations.

General Account Legislation

Mr. Goldberg reported that, at its last meeting, the Pension Committee had authorized staff to go forward with the development of modified general account legislation. As modified, the legislation would have provided prospective relief from the ERISA fiduciary provisions for general account assets and contracts, but, at the same time, would have provided federal remedies and a statutory investment standard as protection for plan participants. Mr. Goldberg further reported that the legislation would also contain a provision that would preclude any causes of action from being brought against an insurance company on the grounds that the company was a fiduciary by virtue of the management of its general account assets or its exercise of discretion under general account contracts prior to the enactment of the legislation.

While work was proceeding on this legislation, word was received from Senators Dodd and Nickles' staff that the House/Senate Budget Reconciliation Bill would be used as a vehicle for ERISA legislation. The Senators further indicated that they would support the ACLI efforts to attach the general account legislation on the Budget Bill provided the ACLI could secure Department of Labor backing. Mr. Goldberg then reported on a meeting held shortly thereafter with the Labor Department. At this meeting, concern was expressed by the Labor representatives with regard to both the grandfathering provision in the ACLI bill and the notion that all contracts that merely provided principal guarantees would no longer be subject to ERISA's fiduciary standards. The Department, further, indicated that the Budget Bill would not become an ERISA vehicle. At the conclusion of the meeting, however, the Department said it would try to get back to the ACLI with further thoughts on both of these issues.

The Committee was informed that, contrary to the impression created at the meeting, the the real estate syndicators were able to get

an amendment on the Budget Reconciliation Bill specifying that, until the issuance of final DOL regulations, Interpretive Bulletin 75-2 would continue to apply to real estate publicly offered partnerships. The Committee was further informed that, as a result of the syndicators' success, the DOL had sent a similar transitional rule that would provide that I.B. 75-2 would continue to apply to insurance contracts until 90 days after the effective date of any regulations dealing with general account issues. After negotiations with the DOL, one exact language of the Bill and legislative history were agreed to by both the DOL and the industry. Mr. Goldberg pointed out that this transitional legislation would not directly deal with the CBOE issue (i.e., the question of whether insurance companies are fiduciaries if they unilaterally exercise the right to amend a contract). On the other hand, the transitional rule would not contain the trade-offs provided for in the comprehensive ACLI Bill, i.e., federal remedies, and an investment standard.

It was reported that as staff was attempting to generate support for the amendment, Senator Metzenbaum objected on the grounds that the industry was attempting, by this legislation, to overturn the Peoria Union decision. It was further reported that, despite attempts, the industry was unable to convince Senator Metzenbaum to change his position and, as a result, efforts to have the transitional rule added to the Budget Reconciliation Bill were unsuccessful. The opportunity does, however, exist, to have this provision added when the Budget Bill goes into conference, and the Committee next considered whether this should be attempted. It was noted that, if the Council were successful in the effort to have the transitional rule added, it would probably be extremely difficult to pursue another more comprehensive legislative solution in the near future. On the other hand, the pressing need for some legislative protection in this area was an important fact to consider.

In discussion, it was pointed out that the transitional legislation would have two helpful attributes: (1) it would enable companies to rely on the more helpful legislative history of I.B. 75-2 (which took account of, for example, IPG Contracts); and (2) it would redirect the focus of the definitional inquiry from the term "guaranteed benefit policy" to "contract or policy of insurance". It was further pointed out

that, if I.B. 75-2 were codified with regard to real estate, any silence with regard to insurance companies would likely raise a negative inference which would be extremely harmful in future litigation. On the other hand, it was noted that the transitional rule would not address the CBOE issue and that silence in this area could create an even more damaging negative inference.

To counteract potential problems in this area, it was suggested that Conference Report language accompanying the temporary rule indicate that it was not dispositive of the overall general account issue, and that the Department of Labor would be studying the question further. It was further suggested that if the temporary legislation was not attached to the Budget Reconciliation measure, it would be imperative that any Conference Report language to the real estate industry's bill indicate that no negative inference should be drawn regarding insurance companies. Finally, the point was made that time was of the essence on this issue.

In view of all these considerations, the Pension Committee voted unanimously in favor of the Council attempting to amend the Budget Reconciliation Bill to codify the status of I.B. 75-2 with regard to life insurance company general asset accounts. It was understood that, even if the industry were successful in achieving enactment of this temporary legislation, efforts to secure enactment of the broader general account legislation would continue.

Section 401(k) Survey Results

Hillel Raskas of the ACLI's Social Research Department Staff reported on the results of a survey asking Pension Committee members to assess the relative amount of disruption to their business created by the various proposals is the Administration's tax reform package affecting Section 401(k) plans. The Committee was asked to rank the proposals into three categories: (1) most disruptive; (2) some disruption; and (3) least disruptive. The items viewed as most disruptive were: (1) restrictions on distributions from 401(k) plans; (2) modification of the 401(k) actual deferral percentage ("ADP test"); and (3) elimination of the preferential tax treatment of lump sum distributions.

It was reported that since the survey was mailed, the Joint Committee on Taxation had issued an option paper for consideration by the Ways and Means Committee dealing with the various pension proposals. With regard to 401(k) plans the option paper would replace the $8,000 maximum allowable deferral in the Administration's proposal, with an unindexed $5,000 maximum deferral amount which would be integrated with any IRA. The option paper would, in addition, replace the individual deferral rate for the highly-compensated under the Administration's proposal with an averaging test; however, the definition of the highly-compensated would be narrowed and a single percentage limit test (125% of average deferral of non-highly paid) would apply to the highly paid. No withdrawals would be allowed from 401(k) plans and changes in the loan rules would deny an interest deduction for any loans attributable to elective contributions.

As a result of the changes embodied in the Joint Taxation Committee option paper, the Pension Committee decided to move two of the questionnaire items to Category 1 (most disruptive) status: Item 8 (limiting the per participant Section 401(k) elective contributions) and Item 5 (modifying the 401(k) ADP test). The Committee also agreed to lower to Category 3 (least disruptive), questionnaire Item 9 (integration of Section 401(k) and IRA contributions).

Finally, staff noted that, with regard to Section 401(k) — as well as other employee benefit issues — the ACLI was a participant in a broader coalition on whose behalf Congressman Beryl Anthony (D-ARK) was planning to offer an amendment regarding Section 401(k) plans. In general, this amendment would retain current law treatment of such plans but place a cap on contributions of $12,000. It was also reported that a resolution had been introduced, sponsored by Congressman Hawkins (D-CAL) and co-sponsored by more than 150 members of the House, that expresses the sense of the House that the tax reform bill should not tax employee benefits. It was noted that the resolution deals with employee benefits generally, and does not specifically mention 401(k) plans. The Committee was asked to contact plan sponsors and urge them to write their Congressmen to support the Hawkins resolution.

Tax Reform

Staff reported on some of the other proposals contained in the Joint Taxation Committee Staff option papers.

With regard to 403(b) annuities, staff noted that many significant changes had been made, designed to bring 403(b) annuities within the 401(k) rules. On 403(b) issues, it was also noted that a Task Force of the Legislative Strategy Group had been formed to deal specifically with this area. With regard to lump sum distributions, the Joint Taxation Committee option would: (1) replace ten year averaging with five year averaging; (2) eliminate averaging for distributions before age 59½; and (3) apply a 15% penalty to all annual distributions in excess of $93,750. Other distribution rules would reverse the current ordering rule for partial withdrawals, and would apply a 15% penalty to all early withdrawals before age 59½. Section 415 limits would be further narrowed; and finally, general non-discrimination rules would be applied to pension and welfare benefit plans. These rules would: (1) impose a uniform mechanical 90% eligibility test; (2) eliminate the "reasonable classification test"; and (3) allow a limited "line of business" or "operating unit" exception from the 90% rule. The Committee was informed that lobbying papers were being prepared for all these issues and that the Council was actively lobbying against all the proposals and keep current law.

Other Issues

A report was given on the Council's October 1, 1985, testimony on the pension policy implications of the President's tax reform proposals on benefit programs and retirement savings before the Labor Subcommittee of the Senate Labor and Human Resources Committee. It was noted that two items were emphasized in the oral testimony given by Pension Committee Chairman John Naughton: (1) that retirement issues are not an appropriate subject for resolution in a tax bill and therefore should be removed; and (2) our principal objections to the Section 401(k) proposal. It was noted that no questions had been asked regarding tax revenues; however Mr. Naughton had been asked how many Section 401(k) arrangements represented new plans, rather than old plan conversions. The question of whether the industry preferred a floor or cap on health benefits was

also asked; on this point the ACLI reply was that the industry was opposed to both proposals.

It was next noted that a member of the Committee was filing a private letter ruling request regarding the status of the P.S. 58 cost basis when a whole life contract is surrendered and transferred to a universal life contract in a qualified plan. According to at least one general information letter sent by the IRS at the request of a taxpayer, it would appear that there is no carryover of the P.S. 58 basis when a whole life contract is surrendered and its cash value is incorporated into or used to pay a single premium for a universal life policy. (It was subsequently heard that the private letter ruling request had been withdrawn when the IRS indicated that it planned to issue an adverse ruling.)

A further item raised was the question of what position the ACLI might take on proposed legislation dealing with plan asset reversions. Legislation proposed by Senator Metzenbaum and incorporated in the Budget Reconciliation Bill would impose a moratorium until March 1, 1986, on all plan asset reversions and would mandate a Labor Department study of this issue, to be completed by February of 1986. It was noted that the APPWP and ERIC were actively opposing this amendment. The question was raised as to: (1) whether the ACLI was sufficiently interested in this issue to get involved; and (2) if so, what the ACLI position should be — particularly in light of attempts to have the industry's general account stopgap legislation added onto this same Budget Bill. In discussion it was suggested that it would not be politically feasible to oppose the asset reversion provision, and, at the same time, urge adoption of our general account provision — particularly since APPWP and ERIC were opposing asset reversion legislation on the ground that budget reconciliation was not the appropriate place for ERISA legislation. The Committee agreed that the ACLI should not oppose the asset reversion provisions in the Budget Reconciliation Bill.

Joint LICONY/ACLI Task Force on the Regulation of Group Annuity Contracts

Mel Altman summarized the status of discussions with the New York Insurance Department on the industry draft regulation, which

provides disclosure rules for group annuity contracts and rules requiring certain participant benefit withdrawals under contracts issued in connection with defined contribution plans to be made without market value adjustment. He noted that there was nothing new to report on the book value portion of the regulation. With regard to disclosure, Mr. Altman reported that the industry had agreed to provide disclosure to not only the plan sponsor but the contractholder as well. With regard to old contracts, although these contracts would be grandfathered under the industry proposal, the issue of how to treat new employees coming under old plans would need to be addressed. On the question of whether the contract could itself serve as a disclosure document, the New York Department had indicated that this would be permissible so long as key items were not "buried" in the contract. Finally, it was noted that, while the initial industry strategy had been to finalize the disclosure and book value issues before going forward with the issue of regulation of market value adjustments, this has now been changed somewhat, and discussions on market value adjustment issues will be pursued so that these issues can be resolved in the context of the disclosure regulation — rather than in the context of a regulation being developed by another group regarding market value adjustments and non-forfeiture values.

The meeting adjourned at 1:00.

PENSION COMMITTEE
1985

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MINUTES FOR THE PENSION COMMITTEE MEETING
MARCH 4, 1986

MINUTES FOR THE PENSION COMMITTEE MEETING
MARCH 4, 1986

The following persons attended:

Jack Naughton, Chairman, Mass Mutual
John Booth, ACLI
Jim Brock, Nationwide
Wally Campbell, State Mutual
Bill Cassidy, National Life of Vermont
Stephen Chiumenti, New England Life
Ken Cohen, Mass Mutual
Gil Cronin, Transamerican Life & Annuity
Dale Denno, Union Mutual
Bill Gould, Bankers Life
Phyllis Gerstell, ACLI
Larry Hershberger, TIAA-CREF
Lynn Jacobs, CIGNA
Jack Joyce, State Mutual
Melissa Kahn, Equitable
David Kalib, Berkshire Life
Lya Kilian, New York Life
Steve Kraus, ACLI
Curt Krause, The Travelers
Dave Levy, O'Neill & Haas
Maureen Mullen, Aetna
Ron Powell, IDS Life
Alan Reed, Lincoln National
Gail Rosenstock, Mutual Benefit Life
John Schmidt, Bankers Life
Tony Spano, ACLI
Gerry Talbot, Metropolitan
Mark Williams, Phoenix Mutual
Henry Winslow, John Hancock

Chairman Naughton opened the meeting at 10:00 a.m. The discussion and action taken by the Pension Committee on the various agenda items considered are set forth below.

Use of Participating Annuities in the
Termination of Over-funded Plans.

Staff provided the Committee with a background summary of this issue. On May 31, 1985, the National Office of the IRS issued a letter to all Assistant Regional Commissioners which indicated that a study had been initiated on the effect on plan qualification status of the use of participating annuity contracts in plan terminations. The letter further noted that, pending release of the study, the issuance of determination letters would be suspended. It was further reported that Congressman Edward Roybal (D-CA) had sent letters to the Internal Revenue Service, Department of Labor and Pension Benefit Guaranty Corporation, requesting that: (1) the PBGC withdraw its opinion letter 85-9 approving the use of participating annuities in connection with over-funded pension plan terminations; and (2) the Department of Labor undertake an expeditious examination of issues relating to the use of such contracts, including any fiduciary and prohibited transaction implications.

To respond to these developments, ACLI staff and member company representatives met, in early January, with individuals from the Internal Revenue Service and Labor Department at two separate meetings to discuss the industry's position on the use of participating annuities in terminating plans. The meeting with the Labor Department was viewed as encouraging, particularly in that representatives of the Department saw no particular fiduciary, plan asset or prohibited transaction problems arising from the use of these contracts. The Department's only expressed concern was with regard to possible manipulation of assets from the ongoing plan by the employer so as to avoid hitting the contractually specified "trigger point" (the level of funds under the participating annuity contract at which annuities would need to be purchased for participants in the terminated plan).

The IRS meeting was viewed as somewhat less successful. Representatives from the Service expressed a variety of concerns with regard to the tax (rather than the employee benefits) aspects of these arrangements. Among the questions raised by the IRS were: 1) is this type of participating annuity a true annuity? 2) are wrap-around annuity issues involved in this context? 3) since amounts in excess

of those needed to purchase a "traditional annuity" go into these contracts, should the contract be split into two parts, with amounts in excess of those needed to purchase a traditional annuity subject to current tax? 4) is there a "segregated asset account" as defined under DEFRA? Underlying all these questions was the concern that employers have the ability to avoid paying current tax on the distribution of amounts in excess of the purchase price of the annuities by putting these excess amounts into the contract, and then gaining access to these funds in the form of dividends from the contract.

The Committee discussed whether any further ACLI action was advisable. For example, it was suggested that the ACLI might prepare a legal memorandum as to how these arrangements should be treated for tax purposes. On the other hand, in light of the wide range of products used in the participating annuity market, it was the consensus of the group that further action would not be warranted at the present time. The Pension Committee, accordingly, agreed that the Council should not take any additional action at present with regard to the use of participating annuities in terminated plans, with the understanding that the item could be re-examined, if need be, at the Committee's next meeting.

Privatization of the Pension Benefit Guaranty Corporation.

Staff reported that the Reagan administration has been interested in developing proposals to reduce the role of the federal government in insuring private pension benefits. As part of this effort, the question has been raised as to whether private insurance companies would have an incentive to take over the Federal role in providing such insurance if an appropriate premium could be developed. In discussion, doubt was expressed as to whether it would be possible to pursue this market with any acceptable degree of risk. Thus, in light of the lack of current interest in providing such a product, the Pension Committee agreed to take no action on this question at the present time. It was understood that ACLI staff would continue to monitor this issue, however, and that, should the GAO or other government-sponsored Task Force or Agency produce a report or study on this topic, the Committee would reconsider its position.

Arbitrage Borrowing by State and Local Governments.

A background report was given on this issue. It was noted that under current law, interest on obligations issued by a state or any political subdivision of a state is generally tax-exempt. Interest on an otherwise tax-exempt obligation, however, is taxable if the obligation is an "arbitrage bond" (i.e., an obligation that is part of an issue more than 15% of the proceeds of which are reasonably expected to be used to acquire taxable obligations that produce a materially higher yield than the yield on the tax-exempt obligation). Under current law, borrowing by state and local governments for the purpose of purchasing annuities from life insurers to fund public pension past service liabilities on retired lives is not considered "arbitrage."

The House-passed Tax Reform Bill (H.R. 3838) makes numerous amendments to the general arbitrage restrictions applicable to all tax-exempt bonds. In particular, the Bill provides restrictions on the types of obligations in which bond proceeds may be invested without regard to yield restrictions. Thus, under the Bill, investment in any deferred payment contract (including an annuity) is precluded if the yield on the contract is materially higher than the yield on the bonds. The Committee Report language to the Bill indicates that the purchase of an annuity contract to fund a pension plan of a qualified governmental unit would be subject to the same arbitrage restrictions as would direct funding of that plan with bond proceeds.

In discussion of what action the Council should take with regard to the H.R. 3838 arbitrage provision, the point was made that in two recent private letter rulings, the Service had found no arbitrage where tax exempt proceeds were used to purchase single premium non-participating insurance contracts. These rulings were premised on the theory that, since the political subdivision cannot use the investment yield, there is no rationale for finding that arbitrage has occurred. Thus, the point was made that perhaps it would be sufficient to seek inclusion of language in the Committee Report to the Bill indicating that the underlying arbitrage provision was not intended to overrule the favorable private letter rulings with regard to purchase of single premium non-participating insurance contracts.

In discussion, concern was expressed as to the strategic ramifications of addressing this aspect of H.R. 3838 without considering the industry's overall legislative priorities. On this point, the Committee was reminded by staff that any position taken by the Pension Committee on a tax reform issue would need to be referred for ultimate approval to the Joint ACLI/HIAA Steering Committee on the Taxation of Employee Benefits, Individual Life Insurance, and Related Issues. Finally, the suggestion was made that, in light of the lack of clarity as to whether the H.R. 3838 provision was meant to distinguish between so-called "real" annuities and "investment annuities" (i.e., guaranteed interest contracts or GIC's), it was not possible to fully ascertain the severity of any potential problems. Accordingly, the Pension Committee agreed that as a first step before taking any further action on this issue, staff would attempt to see if the arbitrage borrowing provision in H.R. 3838 was intended to apply only to GIC's.

Internal Revenue Service Notice 86-3.

Staff reported son recently issued Internal Revenue Service Notice 86-3. This Notice purports to grant partial relief for certain qualified plans that were not timely amended and filed to comply with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1984 (DEFRA) or the Retirement Equity Act of 1984 (REA). The Notice imposes a partial loss of employer deductions for plan contributions and a partial taxation of key employee benefits. The negative tax consequence increase with each month the plan is filed late for a determination letter ruling.

The procedures set forth in Notice 86-3 will apply to employers who had received favorable determination letters for their plans and to employers who had, on or before March 19, 1984, adopted a master or prototype plan for which a favorable post-ERISA opinion letter had been issued. The procedure will apply where such plans were not timely amended to comply with TEFRA, DEFRA or REA (and for which determination letters, as necessary for reliance, were not requested) by the applicable compliance date for each statute.

In discussion of the Notice, three points were made. First, employers need additional time to file without penalty. Second, special consideration needs to be given to employers who adopted filed, (but as yet unapproved), master or prototype plans after March 18, 1984. Third, it was unfair to base the granting of hardship relief on the filing of a determination letter. The Committee therefore agreed that the ACLI should protest the requirement that, to qualify as a "prior adopter", the plan would have to have filed for a determination letter. Staff was requested to request relief from the Notice.

General Account Contracts.

Staff reported on the progress of the Council's legislative and regulatory efforts to clarify the status of ERISA's fiduciary responsibility and prohibited transaction rules with regard to insurance company general account contracts and assets. It was noted that, late last year, real estate syndicators had been successful in inserting a provision in the Budget Reconciliation Bill clarifying that IB 75-2 would continue to apply to them in the absence of further regulatory guidance. To respond to this development, the ACLI sought to have a similar legislative provision inserted in the bill to cover life insurance company general account contracts and assets. When this effort failed, the Council then sought to insert Conference Report language to the Budget Bill clarifying that no negative inference should be drawn with regard to life insurance company general account assets and contracts from the syndicators' provision. The ACLI was successful in this later effort, and the Budget Reconciliation Bill -- including our Conference Report language -- was signed into law by the President on April 7, 1986. The Fiduciary Task Force then discussed the question of how to proceed with the comprehensive general account legislative proposal developed by the group last year. In light of the resistance of the Labor Department to this proposal, it was determined that the legislation was too complicated to be enacted. Therefore, the Task Force recommended that the legislation be placed on hold, and that work, instead, should focus on developing an acceptable life insurance contract "safe harbor" for inclusion in plan asset regulations to be developed by the Department of Labor or legislation if the opportunity presents itself.

New York Insurance Department.

It was reported that a joint ACLI/LICONY Task Force has been working with the New York Insurance Department in developing regulations on three issues with regard to group annuity contracts. The group is near completion with regard to discussion drafts on two items, i.e., 1) appropriate policyholder disclosure rules; and 2) rules as to when book value payments must be made under defined contribution contracts. The group has not proceeded as far with the Department on a third, more controversial topic — that is, the question of when market value adjustments may be made under group contracts. In summarizing the activities of the group, it was stressed that the joint Task Force at present is preparing discussion documents only, and that they will not proceed with any final submission until they have sought formal approval by both LICONY and the ACLI — including the Pension Committee.

REA Hearings.

A report was given on the ACLI's testimony at hearings held by the IRS on the proposed REA regulations. Two of the issues focused on by the Council generated rather hostile questions from the government panel; in particular, opposition was voiced to the ACLI concept that, if a deferred annuity is distributed by a qualified plan to a participant, REA's anti-cutback, survivor benefit, and spousal waiver requirements should not "live on" in their entirety in the new annuity contract. While the ACLI conceded that some of REA's rules should continue to apply in this context, it was the ACLI view that a blanket extension of REA's provision would go way beyond the statute and its legislative history. Moreover, the point was made that if this position were adhered to, insurance companies would be unable to offer these products. Despite these arguments, the view was expressed by the government panel that the Service would not accept the industry's position and that the final regulations would probably come out with this provision intact.

A second point raised in the ACLI testimony draft with the inconsistency in the treatment in the regulations of QPSA ("Qualified Pre-Retirement Survivor Annuity") death benefits. Under the regulations, it would appear that the QPSA for a defined benefit plan must

be based on the participant's account balance before the date of death (i.e., without life insurance proceeds). By contrast, for defined contribution plans, the QPSA would be based on the account balance of the participant on the day after death — that is, including life insurance proceeds. In discussion, the government panel indicated that this provision of the regulation would not be changed.

In general, the overall impression conveyed at the hearings was that the service was very intent on finalizing the REA regulations as they were proposed, and that it is unlikely that there will be any significant change in the regulations of interest to the ACLI.

Retirement Income Policy.

The Pension Committee concluded the meeting with a discussion of possible positions to be taken by the ACLI on specific retirement income issues. A springboard for discussion was the Retirement Income Policy Act of 1985 (RIPA) which had been the subject of recent hearings in Congress, and which was expected to be incorporated in some part by the Senate Finance Committee during its mark-up of a tax reform bill.

Limits on Contributions, Benefits and Elective Contributions

The Pension Committee agreed that RIPA's approach of linking the Section 415 and Section 401(k) limits to the Social Security taxable wage base was desirable. The Committee did not, however, agree with the specific benefit/contribution levels contained in RIPA — particularly the reduced dollar limits for defined contribution plans and Section 401(k) plans. As an alternative, the following was suggested:

1) Defined benefit plans — the lesser of 100% of compensation or 200% of the Social Security taxable wage base ($84,000 for 1986);

2) Defined contributions plans — the lesser of 25% of compensation or 50% of the Social Security taxable wage base with a minimum dollar limit floor of $25,000.

3) Elective contributions to 401(k) plans — a dollar limit equal to 25% of the Social Security taxable wage base ($10,500 for 1986),

but with a transitional floor dollar limit of $15,000. The special RIPA limit for nonretirement plans (i.e., thrift and profit-sharing plans) would be deleted.

Retirement/Nonretirement Plans

The Pension Committee rejected the retirement/nonretirement plan distinction which is the core concept of RIPA. The Committee felt that the concerns of RIPA's sponsors as to potential diversion of retirement benefits for nonretirement purposes could be better addressed via appropriate withdrawal rules.

Withdrawals

The Pension Committee suggested a two-tier approach to hardship withdrawals. The first tier of withdrawals would be triggered by unanticipated events such as: 1) major, uninsured medical expenses; 2) long-term disability; and 3) involuntary unemployment followed exhaustion of any unemployment compensation benefits. Withdrawals for this category of hardships would not be subject to any excise or recapture tax contained in the tax reform proposals.

The second tier of hardship withdrawals would include college tuition payments or the purchase of a principal residence. Second tier hardships would be permitted, but would be subject to a tax which would recapture the tax advantages of income deferral under a qualified plan. If it were found that an appropriate recapture tax could not be designed, the Committee would consider a reasonable flat percentage excise tax.

The Committee was of the opinion that in-service withdrawals by active employees and cash-outs on separation from service should continue to be permitted, as under current law, from profit-sharing, thrift and savings plans without additional tax. However, the Committee agreed that some political concession to discourage diversion of retirement benefits for preretirement purposes might be necessary. (The approach taken under the House passed tax bill, H.R. 3838, to accomplish this end is to impose a 15% excise tax on the taxable amount of distributions made prior to age 59½.)

The Committee agreed that a recapture or excise tax was preferable to a flat prohibition on withdrawals. In the Committee's view, such a flat prohibition would greatly discourage participation in contributory arrangements which would, in turn, diminish coverage under private retirement plans. The Committee suggested that, at the very least, the age 59½ cut-off point for distributions that would be free of excise tax should be lowered to age 55 to take account of common early retirement practice. For distributions prior to age 55, it was agreed that it there must be some tax, the ACLI should seek a recapture tax or, in the alternative, a flat percentage lower than 15%.

As to the treatment of lump sum distributions, the Pension Committee agreed to accept the 5-year averaging proposal in H.R. 3838 — with the reservation that the age 59½ minimum age be lowered to age 55.

Finally, the Pension Committee agreed that it was extremely important to seek to retain the current law FIFO ordering rules on withdrawals prior to the annuity starting date. (The House passed tax bill would reverse the ordering rules and treat the first money coming out of a thrift plan as untaxed earnings.) A pro rata approach was suggested as a possible compromise. However, concern was expressed that such an approach would be complex to administer.

Vesting

The Pension Committee agreed that some form of more rapid vesting could be supported, although several problems were raised with the 5 year/100% vesting proposed in RIPA.

Integration with Social Security

The Pension Committee agreed that further changes in the rules regarding integration with Social Security along the lines of the RIPA proposals were acceptable. The Committee noted, however, that the Social Security offset proposal could result in lower-paid employees receiving a combined retirement benefit in excess of 100% of final compensation and excessive aggregate benefits for middle-level employees. To correct this problem an upward adjustment in the offset formula or a cap on aggregate benefits would be needed.

Coverage

The Pension Committee agreed that, absent demonstration of abuse, the current law coverage tests should be retained. However, the Committee further agreed that if it were demonstrated that significant abuse was occurring under the current law rules, some tightening of the current law percentage tests would be considered. In any event, it would be important to seek retention of an alternative, "fair cross section", test as under current law.

The meeting adjourned at 1:30 p.m.